S. HRG. 98-630

TRUST FOR INVESTMENT IN MORTGAGES PROPOSAL AND TAX TREATMENT OF SECONDARY MORTGAGE MARKET

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1822

NOVEMBER 4, 1983

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
31-489 O WASHINGTON : 1984

S361-20

COMMITTEE ON FINANCE

ROBERT J. DOLE, Kansas, *Chairman*

BOB PACKWOOD, Oregon	RUSSELL B. LONG, Louisiana
WILLIAM V. ROTH, JR., Delaware	LLOYD BENTSEN, Texas
JOHN C. DANFORTH, Missouri	SPARK M. MATSUNAGA, Hawaii
JOHN H. CHAFEE, Rhode Island	DANIEL PATRICK MOYNIHAN, New York
JOHN HEINZ, Pennsylvania	MAX BAUCUS, Montana
MALCOLM WALLOP, Wyoming	DAVID L. BOREN, Oklahoma
DAVID DURENBERGER, Minnesota	BILL BRADLEY, New Jersey
WILLIAM L. ARMSTRONG, Colorado	GEORGE J. MITCHELL, Maine
STEVEN D. SYMMS, Idaho	DAVID PRYOR, Arkansas
CHARLES E. GRASSLEY, Iowa	

RODERICK A. DEARMENT, *Chief Counsel and Staff Director*
MICHAEL STERN, *Minority Staff Director*

CONTENTS

Administration Witnesses

Woodward, Hon. Robert G., Tax Legislative Counsel, Department of the Treasury, accompanied by Andrew E. Furer ..... Page 42

Public Witnesses

Page

Carl, Bernard J., Esq., Williams & Connolly, and former chairman, Housing Commission Committee, President's Commission on Housing 59
Cumberland, William E., general counsel, Mortgage Bankers Association of America 108
Federal National Mortgage Association, David O. Maxwell, chairman and chief executive officer 200
First Boston Corp., William P. McCauley, vice president, Mortgage Products Group 176
Garn, Hon. Jake, a U.S. Senator from Utah 26
Hall, Peter, president, P.M.I. Mortgage Insurance Co., on behalf of Sears Roebuck & Co 79
Hallbauer, Barbara A., executive vice president, Norwest Mortgage, Inc., and Residential Funding Corp 75
Levy, Gerald J., president, Guaranty Savings & Loan Association on behalf of the United States League of Savings Institutions 125
Maxwell, David O., chairman and chief executive officer, Federal National Mortgage Association 200
McCauley, William P., vice president, Mortgage Products Group, First Boston Corp 176
Merrill Lynch Mortgage Capital, Inc., Richard T. Pratt, president 188
Mortgage Bankers Association of America, William E. Cumberland, general counsel 108
National Association of Home Builders, Harry Pryde, president 91
National Council of Savings Institutions, John Tuccillo, vice president, economics and research 143
Norwest Mortgage, Inc., Barbara A. Hallbauer, executive vice president 75
Pratt, Richard T., president, Merrill Lynch Mortgage Capital, Inc 188
Proxmire, Hon. William, a U.S. Senator from Wisconsin 35
Pryde, Harry, president, National Association of Home Builders 91
Ranieri, Lewis S., managing director, Soloman Bros., Inc 166
Sears Roebuck & Co., Peter Hall 79
Soloman Bros., Inc., Lewis S. Ranieri, managing director 166
Tower, Hon. John, a U.S. Senator from Texas 15
Tuccillo, John, vice president, economics and research, National Council of Savings Institutions 143
United States League of Savings Institutions, Gerald J. Levy, chairman, Task Force on Mortgage Securities 125
Williams & Connolly, Bernard J. Carl, Esq 59

Additional Information

Committee press release 1
Description of S. 1822 by the Joint Committee on Taxation 2
Prepared statement of Senator John Tower 18
Prepared statement of Senator Jake Garn and a letter from the American Council of Life Insurance 29
Prepared statement of Senator William Proxmire 38

Page

Prepared statement of Hon. John E. Chapoton 45
Prepared statement of Bernard J. Carl 61
Prepared statement of Barbara A. Hallbauer 76
Prepared statement of Peter Hall 80
Prepared statement of Harry Pryde 92
Prepared statement of William E. Cumberland 109
Prepared statement of Gerald J. Levy 126
Prepared statement of John Tuccillo 144
Prepared statement of Lewis S. Ranieri 168
Prepared statement of William P. McCauley 178
Prepared statement of Richard T. Pratt 189
Prepared statement of David O. Maxwell 202

COMMUNICATIONS

American Bankers Association 214
Mortgage Insurance Cos. of America 217
National Association of Realtors 221
Public Securities Association 226

TRUST FOR INVESTMENT IN MORTGAGES PROPOSAL AND TAX TREATMENT OF SECONDARY MORTGAGE MARKET

FRIDAY, NOVEMBER 4, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:50 a.m. in room SD-226, Dirksen Senate Office Building, Hon. John C. Danforth presiding.

Present: Senators Danforth and Long.

Also present: Senators Tower, Proxmire, and Garn.

(The press release announcing the hearing, background material on S. 1822 relating to Trusts for Investments in Mortgages by the Joint Committee on Taxation follows:)

[Press Release No. 83-188]

PRESS RELEASE

FOR IMMEDIATE RELEASE, OCTOBER 7, 1983

UNITED STATES SENATE, COMMITTEE ON FINANCE, SD-219 DIRKSEN SENATE OFFICE BUILDING

FINANCE COMMITTEE ANNOUNCES HEARING ON TIM'S PROPOSAL AND TAX TREATMENT OF SECONDARY MORTGAGE MARKET

Senator Robert J. Dole (R., Kans.), Chairman of the Committee on Finance, announced today that a hearing will be held on Friday, November 4, 1983 on the TIM's proposal and the tax treatment of the secondary mortgage market.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The following legislative proposal will be considered:

S. 1822.—Introduced by Senator Garn for himself and Senator Tower. S. 1822 would amend the tax law to facilitate investments in home mortgages through a new trust instrument called TIMs (Trust for Investment in Mortgages).

Senator Dole stated that "the Committee would also be reviewing generally the tax treatment of mortgage investments and the secondary mortgage market institutions." Senator Dole invited interested witnesses to submit testimony on these broader issues, as well as on the specifics of S. 1822.

DESCRIPTION OF S. 1822 (RELATING TO TRUSTS FOR INVESTMENTS IN MORTGAGES)

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON NOVEMBER 4, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet provides a description of S. 1822 (introduced by Senators Garn and Tower) relating to "trusts for investments in mortgages," which is scheduled for a public hearing on November 4, 1983, by the Senate Committee on Finance.

The first part of the pamphlet provides an overview of present law. The second part contains a brief discussion of the issues raised by S. 1822. The third part provides a description of S. 1822.

ERRATA SHEET FOR JCS-55-83
(November 3, 1983)

(1) On page 3, the first sentence of the paragraph headed, "Rules for classifying entities as corporations," should read as follows:

"Under the Internal Revenue Code, an unincorporated entity is generally classified as an "association," which is taxable as a corporation if it more nearly resembles a corporation than an unincorporated entity." (The underlined word is the corrected word.)

(2) On page 4, in the third paragraph headed "Partnerships", the first sentence should read as follows:

"A form of indirect ownership is through ownership of an interest in a partnership." (The underlined word is the corrected word.)

(3) On page 5, the second phrase in the last sentence in the first paragraph headed "Real estate investment trusts," should read as follows:

"; income that is not currently distributed to shareholders is taxed at the REIT level as in the case of normal corporations." (The word "also" should be deleted.

(4) On page 7, the last sentence in the first paragraph headed, "Corporate obligations," should read as follows:

"Interest income and expense are lower in earlier years under the constant interest rate method compared to the straight-line method." (The word underlined is the corrected word.

(5) On page 7, the last sentence in the second paragraph headed "Obligations issued by natural persons," should read as follows:

"Discount on debt obligations issued by natural persons is taken into income by cash basis taxpayers proportionately as principal is paid." (The word "not" should be deleted.)

I. PRESENT LAW

Overview

Taxation of alternative methods of owning income-producing assets.—Under present law, income-producing assets (such as mortgages on residential property) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly is generally taxed to the owner of the property and, thus, is subject to only one level of taxation. Income from property owned indirectly is subject to one or two levels of taxation depending on whether the intermediary entity is treated for tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) under which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Also, under present law, interest on debt used to finance the acquisition of income-producing assets generally is deductible to the person incurring the debt. To the extent that a person providing capital in the form of debt (i.e., a debt holder) can be viewed as an owner of the income-producing assets, the deduction for interest insures that there is only one level of taxation on any income from those assets that is paid to that debt holder.

Rules for classifying entities as corporations.—Under the Internal Revenue Code, an unincorporated entity is generally classified as an "association," which is taxable as a corporation if it more nearly resembles a corporation or an unincorporated entity. For these purposes, an unincorporated entity is not classified as an association and treated as a corporation for tax purposes unless such organization has more corporate characteristics than noncorporate characteristics not taking into account characteristics common to both corporations and the unincorporated entity.[1] The standards for determining the classification of an entity are set forth in Treasury Regulations under section 7701. Under these regulations, there are a number of principal characteristics which generally distinguish corporations from other entities. These characteristics are: (1) associates, (2) an objective to carry on business, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests (Treas. Reg. sec. 301.7701-2(a)(1)).

---

[1] See also *Morrisey et al v. Commissioner*, 296 U.S. 344 (1935), *Arthur B. Kintner* v. *United States*, 216 F.2d 418 (9th Cir. 1954); and *Glensder Textile Co.*, 46 B.T.A. 176 (1942).

Indirect Ownership Entities

Separate taxable entities

Corporations.—One form of indirect ownership of property is the ownership of stock in a corporation that owns the property. Corporations can be used to hold investment property or to engage in the active conduct of a trade or business.

Corporations are treated for tax purposes as separate taxable entities, apart from their shareholders. Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, such earnings are also taxed to the stockholders.[2]

Complete conduit entities

Partnerships.—A form of indirect ownership is through ownership in an interest in a partnership. For tax purposes, a partnership is an unincorporated organization through, or by means of which, any business, financial operation or venture is carried on, and which is not a corporation, a trust or an estate under the Code. For tax purposes, a partnership is generally treated as a complete conduit for tax purposes.[3] Each partner includes in income his "distributive share" of the partnership's taxable income, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership without regard to whether the income of the partnership is actually distributed to the partners. Similarly, partnership losses, deductions, and credits pass through to the partners and can be used to offset other income.

S Corporations.—Another form of indirect ownership of property is ownership of stock in an S corporation. Although S corporations are corporate entities, S corporations are generally treated for tax purposes as complete conduits (i.e., the income of the S corporation is includible in the taxable income of its shareholders).[4]

In order to qualify for S corporation treatment, a corporation must be a "small business corporation." For these purposes the term "small business corporation" is defined as a domestic corporation which is not an "ineligible corporation" and which does not have (1) more than one class of stock, and (2) more than 35 shareholders. In addition, for a corporation to qualify as an S corporation, none of its shareholders can be corporations or nonresident aliens. The term "ineligible corporation" refers to any corporation which is (1) a member of an affiliated group, (2) a financial institution to which section 585 or 593 applies, (3) an insurance company subject to tax under subchapter L, (4) a 936 corporation, or (5) a DISC or former DISC.

---

[2] An individual is generally allowed to exclude from taxable income up to $100 of dividends per year (sec. 116). Corporations are entitled to a dividends received deduction for 85 or 100 percent of dividends received each year (secs. 243-245).

[3] A partnership is treated as an entity separate from its partners for purposes of calculating taxable income, deduction, and credit. It also is treated as an entity for purposes of reporting information to the Internal Revenue Service.

[4] An S corporation may be subject to tax at the entity level under certain limited circumstances.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT").[5] Under the provisions of the Code applicable to REITs (secs. 856-859 and sec. 860), REITs generally are treated, in substance, as conduits for tax purposes. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders also is taxed at the REIT level as in the case of normal corporations.

A corporation, or an unincorporated trust or association that would be treated as a corporation for tax purposes, can qualify as a REIT if: (1) it is managed by one or more trustees or directors; (2) beneficial ownership is evidenced by transferable shares, or by transferable certificates of beneficial interest, held by 100 or more persons; (3) it is neither a financial institution or an insurance company; (4) it would not be a personal holding company (as defined in sec. 542) if all of its adjusted ordinary gross income (as defined in section 543(b)(2)) were personal holding company income (as defined in sec. 543); (5) it meets certain income and asset tests, described below; and (6) it meets a distribution requirement, described below.

Under the income tests, at least 75 percent of a REIT's income must be derived from (1) rents from real property, (2) interest on obligations secured by real property, (3) gain from the sale or other disposition of real property (or interests therein, including mortgages), (4) distributions from other REITs, (5) gain from the disposition of shares of other REITs, (6) abatements or refunds of taxes on real property, and (7) income and gain on property which qualifies as foreclosure property. Further, at least 95 percent of the REIT's income must be derived from these sources, and from other interest, dividends, or gains from the sale of stock or securities. Finally, under the income tests, income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income.[6]

A REIT satisfies the asset tests if, at the close of each quarter of its taxable year, at least 75 percent of the value of its assets is represented by real estate, cash and cash items (including receivables), and government securities. Further, the REIT's investments must meet certain diversification requirements.

---

[5] Another form of indirect ownership is the ownership of shares in a regulated investment company ("RIC"). RICs issue shares to investors and invest the proceeds in a diversified portfolio of securities. As in the case of a REIT, RICs are generally treated as conduits for tax purposes. (i.e., RICs are allowed a deduction for earnings distributed to shareholders.) It is understood that RICs cannot be used for pooling mortgages and issuing mortgage-backed securities because the requirements for qualification as a RIC under section 851 cross reference to investment companies registered under the Investment Company Act of 1940, or to common trust funds excluded under section 3(c)(3) of such Act, and mortgage vehicles are exempt from registration pursuant to section 3(a)(5) of that Act.

[6] For purposes of the income test, gross income does not include income from "prohibited transactions," which is subject to a 100-percent tax. Generally, the term "prohibited transaction" means a sale or other disposition of property described in section 1221(1) (other than foreclosure property). However, under certain circumstances, the sale of a real estate asset which has been held for at least 4 years is not a prohibited transaction.

Finally, a REIT satisfies the distribution requirement if it distributes at least 95 percent of its ordinary income on a current basis.[7]

Trusts.—Another form of indirect ownership of property is to own the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust is treated as a partial conduit for tax purposes. This partial conduit treatment is achieved by allowing trusts a deduction the amounts distributed to its beneficiaries.

A fixed investment trust is a trust used to hold a diversified portfolio of investments for its beneficiaries. Such a trust will be treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[8]

Direct ownership entities

Grantor trusts.—A grantor trust is an arrangement under which legal title to property is transferred to a trustee but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for tax purposes (Code secs. 671-679). Thus, income deductions and credits of the grantor trust are attributed directly to the grantors. In some cases, persons other than the transferor are treated as owners of the trust's assets.

Tax Treatment of Discount

In general

Under present law, different rules apply to the taxation of original issue discount and market discount on debt obligations. Generally, original issue discount ("OID") is the spread between the issue price and the redemption price of a debt obligation that is issued for less than its redemption price. Market discount is the spread between the purchase price paid to a holder of a debt obligation on the sale of the debt obligation and the original issue price of the debt obligation. Generally, market discount arises from increases in the market interest rate over the rate of interest on the debt obligation at the time of issue.

---

[7] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT that, acting in good faith, has failed to satisfy the distribution requirement, could avoid disqualification.

[8] The determination of whether an organization is to be treated for tax purposes as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom. If the trustees have the exclusive responsibility for the protection and conservation of the property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates in a joint enterprise for the conduct of business for profit, and the organization will generally be treated as a trust. (Because centralization of management, continuity of life, free transferability of interests, and limited liability are common to both trusts and corporations, these characteristics are generally not taken into account). An arrangement is not treated as a trust for Federal income purposes if the role of the trustee is not limited to the protection and conservation of the trust corpus. Thus, if a trust is used for carrying on a profit-making business that would ordinarily be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust. However, a trust that is used to hold income-producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment (Treas. Reg. sec. 301.7701-4).

Corporate obligations

Under the code, OID on a corporate obligation, or on an obligation issued by a unincorporated issuer other than a natural person, is included in income by the holder of the obligation, and deducted by the issuer, using a constant instant rate method. Under this method, the interest income and expense are not recognized ratably over the term of the debt obligation, but instead are recognized when earned or incurred. Interest income and expense are higher in earlier years under the constant interest rate method[9] compared to the straight-line method.

Obligations issued by natural persons

To the extent that discount on debt obligations issued by natural persons is accrued by accrual basis taxpayers, it is accrued proportionately as principal is paid or is due. Discount on debt obligations issued by natural persons is not taken into income by cash basis taxpayers proportionately as principal is paid.

[9] Under the constant interest rate formula, the OID is allocated over the life of the debt obligation through a series of adjustments to the issue price for each period of the debt obligation. The adjustment to the issue price for any period of the debt obligation is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the period of the debt obligation) by the obligation's yield to maturity, and then by subtracting the interest payable during the period of the debt obligation. The adjustment to the issue price for any period of the debt obligation is the amount of the OID allocated to that period of the debt obligation.

II. ISSUES

The bill would create an additional type of entity for the indirect ownership of residential mortgages and interests in residential mortgages, to be known as a trust for investment in mortgages ("TIM"). Under present law, corporations, S corporations, partnerships, REITs, unit investment trusts, and grantor trusts can be used as vehicles for indirect investments in mortgages. Each of these, however, have the following disadvantages:

(1) Use of a corporation to pool mortgages would result in an entity level tax.[1]

(2) Prior to the recent revision of the Code provisions relating to such corporations, S corporations (referred to under prior law as subchapter S corporations) could not have passive investment income. Further, under present law, only individuals can acquire shares of S corporation stock and the maximum number of shareholders is limited to 35.

(3) State laws may restrict the acquistion by institutional investors of interests in limited partnerships.

(4) A REIT must have at least 100 shareholders.

(5) Interests in fixed investment trusts are not attractive investments because of the requirement that the trustee not have the power to vary investments. In addition, the character of the underlying assets as derived from real property may not flow through a trust (unless the trust is a grantor trust) which is important for certain tax benefits of REITs and thrift institutions.[2]

(6) The grantor trust format is subject to certain limitations. First, there can be no active management of the mortgages in the trust, and no reinvestment of regular installments of interest or early recoveries of principal or interest. Second, it is unclear whether beneficial interests in a trust can differ as to amount and as to kind. As a result, only one class of mortgage-backed securities can be issued by a pool using the grantor trust format.

The stated purpose of the TIM is to provide an indirect investment entity which does not have these disadvantages. However, the proposal raises a number of issues—

First, is it appropriate to create another conduit for investments in mortgages under the tax laws.

Second, is it appropriate to permit conduit treatment for a entity even though the managers of the assets held by the entity will

---

[1] The corporate form has been used in a number of transactions where current corporate level tax has apparently been avoided by structuring the mortgage-backed securities as debt instruments for tax purposes and using the interest deduction to offset income at the corporate level.

[2] Interests in unit investment trusts would not be attractive investments for these institutions because (i) the interest income would not be considered "interest on obligations secured by mortgages on real property" for purposes of section 856(c)(3)(B); (ii) the certificates would not be considered "real estate assets" for purposes of section 856(c)(5)(A); and (iii) the certificates would not be considered as representing "loans secured by an interest in real property" within the meaning of section 7701(a)(19).

have investment discretion? Similarly, should conduit treatment be provided for a entity that can issue several classes of securities?

Third, should the amount of debt that a TIM can issue be limited?

Fourth, is the treatment of discount on residential mortgages proper under present law?

Fifth, should foreign investors in TIMs be treated as being engaged in a domestic trade or business?

Sixth, is it appropriate to exclude the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation from being eligible trustees of a TIM?

III. DESCRIPTION OF THE BILL

Explanation of Provisions

Qualification as a TIM

In general.—Under the bill, a TIM would be a corporation or trust the ownership of which is evidenced by one or more classes of transferable shares, which is not a bank, thrift institution, or insurance company, which elects to be treated as a TIM, and which meets gross income tests, an asset test, and certain stock ownership rules.

Gross income tests.—Under the bill, at least 75 percent of the TIM's gross income must be derived from qualified obligations; 95 percent must be derived from such obligations, cash, cash items (including receivables), and Government securities. For these purposes, gross income does not include income from certain transactions called prohibited transactions (described below). Also, under the income test, no more than 20 percent the amount of gross income can be derived from the disposition of stocks or securities held for less than 1 year or from prohibited transactions. No amount of gross income can be derived from the active conduct of a trade or business. Commitment fees and points in connection with any qualified obligation would not be treated as income from the active conduct of a trade or business unless such income is for services performed by the TIM. Special rules apply to newly formed TIMs and to TIMs in the process of liquidation.

Prohibited transactions.—Under the bill, prohibited transactions are transactions involving the disposition by a TIM of (1) any qualified obligation that it has held for less than 3 years, or (2) any qualified obligation which, in the hands of the trust, is property described in section 1221(1) (subject to exceptions for certain limited dispositions, and certain dispositions in connection with a liquidation of a TIM which has been a TIM for at least 3 taxable years prior to the disposition). Dispositions in connection with the prepayment, retirement, or renegotiation of a qualified obligation, or of defective obligations, foreclosure property or qualified short-term investments would not be prohibited transactions. Similarly, a disposition in connection with the involuntary liquidation or dissolution of a TIM would not be a prohibited transaction.

Asset test.—Under the asset test, at the close of each quarter of the taxable year, at least 85 percent of the TIM's total assets must consist of qualified obligations, cash, cash items (including receivables), and Government securities. Qualified obligations would include qualified first or second mortgages, qualified participations in such loans, cash flow mortgage-backed bonds secured by any qualified first or second mortgage, qualified repurchase agreements col-

laterized by such loans, shares of other TIMs, and qualified income investments.

A qualified first or second mortgage would be any first or second mortgage, whether or not insured, which is secured by a single-family residence which is the principal residence of the mortgagor, and is used to acquire, or to make a home improvement in connection with, such residence. The amount of any qualified mortgage is limited by reference to the fair market value of the residence. Construction loans would not be qualified first or second mortgages. Further, except as provided in Treasury Regulations, mortgages issued at a discount would not be qualified first or second mortgages.

Any participation in a mortgage or pool of mortgages would be a qualified participation if (1) the mortgages would be qualified first or second mortgages if held directly by the TIM, and (2) the mortgagees of the mortgages remain the primary obligors. A qualified repurchase obligation would be a first or second mortgage that is subject to a repurchase agreement with respect to which (1) the TIM purchases the mortgage for not more than fair market value, (2) any amount payable to the TIM does not exceed the payments due on the mortgage, and (3) the amount payable is fixed at the time of the agreement.

Qualified income investments would include any security, letter of credit, certificate of deposit, surety bond, or other similar instrument or device which (1) is acquired during the 18-month period beginning on the date the TIM is incorporated or formed and (2) is acquired to provide cash to meet fixed obligations of the TIM which cannot be met from investments in other qualified investments, or to provide income to the TIM to offset income which is lost by reason of the prepayment or liquidation of any qualified obligation prior to maturity. Qualified income investments do not include any investment after the earlier of (1) the date which is 7 years after a TIM is incorporated or formed or (2) in the case of a TIM with a fixed term, the date on which the first one-third of such term has expired.

Stock ownership rules.—A TIM would be permitted to issue multiple classes of stock or other equity interests, but only if (1) the outstanding indebtedness of the TIM is limited to 10 percent or less of the aggregate face amount of its assets and (2) the par value of such stock or other equity interest equals the aggregate of the qualified obligations held by the TIM.

Rules governing election as a TIM.—The bill provides special rules governing how the election to become a TIM is to be made, how the election may terminate or can be revoked, and how a TIM can re-elect after a prior termination or revocation.

Ineligible trustees

Under the bill, the Federal National Mortgage Association[1] and the Federal Home Loan Mortgage Corporation[2] would not be eligible trustees, directors, or shareholders of a TIM.

Tax Treatment of a TIM

Under the bill, the shareholders of the TIM would be taxable on the income of a TIM (under rules described below); the TIM would be exempt from Federal income tax. In order to determine the amount taxable to its shareholders, a TIM would be required to compute its taxable income. For this purpose, all TIMs would be on the cash method of accounting using a calendar year. Under the bill, the basis to a TIM of mortgages contributed for TIM stock would be the fair market value of such mortgages at the time of the transfer.

Under the bill, a penalty tax would be imposed on each prohibited transaction of a TIM. The amount of the tax would be 100 percent of the gain or loss allocable to the transaction.

Taxation of Shareholders

Under the bill, shareholders of a TIM would be treated as if the TIM were a partnership and the shareholders were partners.[3] If the proceeds from the disposition by a TIM of any qualified obligation are distributed to a shareholder, the portion of the distribution which is properly allocable to the principal amount of the obligation would be treated as received in redemption of the shareholder's shares and the character of the gain would pass through to the shareholders. However, any gain allocated to (1) a 20-percent shareholder who is a dealer in qualified obligations, or (2) a bank, thrift institution, or REIT, would be treated as ordinary income. If the proceeds from the disposition by a TIM of a qualified obligation are used by the TIM to acquire qualified obligations, each shareholder would be treated as having (1) received a distribution of the shareholder's pro rata share of such proceeds and (2) contributed such amount to the TIM in exchange for shares having a par value equal to the face amount of the acquired qualified obligations.

Under the bill, gain or loss would be recognized by a person transfering a qualified mortgage to a TIM to the extent such person's basis in such mortgage is greater (or less) than the fair market value of such mortgage. Such gain or loss would be ac-

---

[1] The Federal National Mortgage Association (FNMA) is a Federally chartered private corporation that provides a secondary market for residential mortgages. FNMA was organized in 1938 as a corporation wholly owned by the Federal government. In 1954, it became a mixed-ownership corporation owned partly by private shareholders. In 1968, the original corporation was split by Congress into two entities—the Government National Mortgage Association and the Federally chartered private Federal National Mortgage Association. FNMA is subject to Federal income tax. Under the Miscellaneous Revenue Act of 1982 (Pub. L. 97-362), FNMA is allowed a 10-year carryback and a 5-year carryover for net operating losses (other than mortgage disposition losses) for any taxable year beginning after December 31, 1981. Under that legislation, FNMA is allowed a 3-year carryback and 15-year carryover for mortgage disposition losses.

[2] The Federal Home Loan Mortgage Corporation was chartered by the Congress in 1970 to provide a secondary market for residential mortgages originated by thrift institutions. It received its initial capital through the sale of stock to the twelve regional Federal Home Loan Banks, which are owned by privately-held savings and loan institutions. Pursuant to its charter, the Federal Home Loan Mortgage Corporation is exempt from Federal income taxes.

[3] The bill is unclear whether the special allocation rules (and other rules applicable to partnerships) would apply.

counted for ratably over the remaining term of the mortgage. If any loss recognized under this provision is an ordinary loss, subsequent gain from the sale or exchange of the taxpayer's interest in the TIM would be treated as ordinary income to the extent of the ordinary loss.

Effective Date

The bill would be effective on the date of enactment.

Senator DANFORTH. Gentlemen, I am sorry to keep you waiting; I didn't know I was going to be here until 2 minutes ago.

I am glad to see such a distinguished group, with Senator Proxmire, Senator Tower, and Senator Garn.

Senator Proxmire, your name is first on the list. How would you like to start?

Senator PROXMIRE. I understand that Senator Tower is our first choice here. Is that right?

Senator DANFORTH. All right.

Senator GARN. Senator Danforth, he is the chief sponsor of the bill, so if he could go first we would appreciate it.

Senator DANFORTH. Good.

STATEMENT OF HON. JOHN TOWER, U.S. SENATOR FROM THE STATE OF TEXAS

Senator TOWER. I thank my two colleagues, and I want to thank the Finance Committee and commend the committee for holding these hearings on S. 1822 and other issues affecting the secondary mortgage market.

Mr. Chairman, I have provided a full statement which I ask be incorporated in the record, and I will summarize that statement. If that can be incorporated along with other material that I have supplied for the record, I would be grateful.

Senator DANFORTH. Very well.

Senator TOWER. Mr. Chairman, I first learned about TIM's, which is an acronym for Trust for Investment in Mortgages, from Shannon Fairbanks, then a member of the White House staff, when I was preparing for a General Electric housing conference last spring.

The administration has researched this proposal long and hard, and for many, many months we heard that at any moment the TIM's concept would be hardened into a legislative proposal and sent to the Congress. Unfortunately, the administration's TIM's legislation was not available by the time we were ready to introduce our secondary mortgage market bills in August. Because both S. 1821, which I believe has now been redesignated S. 2040, and S. 1822 are complementary, and both bills embody recommendations made by the President's Commission on Housing and Mortgage-Backed Securities, we decided to introduce our own TIM's bill to start the legislative process. It appears to have worked, and I understand the administration will describe their TIM's proposal today and will send it to the Hill next week.

The administration's active participation in these discussions before Congress is welcomed and long awaited. I welcome and look forward to their testimony.

S. 1822, of course, was our best guess concerning how a TIM would look and operate, and I will be the first to admit that regarding the fine technicalities of the tax law it is far from perfect.

The tax changes are required to insure that private entities can design a mortgage-backed security that is more competitive and more attractive to capital investors than traditional mortgage pass-through securities.

The Tax Code problem essentially involves the rigidity of the Internal Revenue Code's grantor trust provisions. These grantor trust rules are very strict, essentially permitting minimal passive management of the trust to insure the passthrough to the shareholders of principal and interest payments on the mortgages. The inability to have more active management of the pool causes the following problems in creating mortgage-backed securities which are attractive to many investors:

First, there is not call-protection. Unlike a 12-year bond which an investor knows will not be called or paid off until the end of the 12 years, mortgage-backed securities may be paid off if the underlying mortgages are prepaid by the mortgagee. Investors can't predict the duration of the investment for today's mortgage-backed securities.

Second, there is passthrough of payments on a monthly basis. Most investors have indicated a preference for semiannual payments on bonds, for instance. Under TIM's, the manager of a grantor trust could hold back the monthly principal and interest payments at the pool level and make investor payments less frequently.

Finally, there is only one class of securities. The TIM's security could be structured to issue two or more classes of securities with different characteristics, to attract different investors.

I would like to reiterate something the President's Commission has pointed out: These disadvantages appear to be largely inadvertent consequences of past policy decisions. In our research on the changes needed to develop broad and active markets for conventional mortgage-backed securities we found time and time again that securities laws, banking statutes, and various regulatory proclamations which now apply to mortgage-backed securities were promulgated when these securities did not even exist.

Again, I will just summarize the reasons why I think all of the TIM's proposals, including its centerpiece, the tax package, should be enacted:

First, TIM's securities will enable private entities to create more competitive mortgage-backed securities, appealing to investors who have so far placed a small percentage of their funds in mortgage assets.

Second, the objective of these TIM's proposals is to provide tools for a nacent private sector to grow and prosper in the secondary mortgage market. Private participants are badly need to compete in a market dominated by the federally sponsored agencies.

Finally, the TIM's securities will create a potent economic tool for private entities which should—and this is enormously important, Mr. Chairman—which should significantly lower financing costs to home buyers. This, we hope, will stimulate the residential housing market.

Now, I want to commend the chairman for convening these hearings. Mortgage revenue bonds, the MRA concept, the Condominium Cost-Reduction Act, and now TIM's, all involve modifications of the Tax Code, which in turn are major items in our national housing policy.

The Finance Committee and the Banking Committee, I think, must increasingly work together as more and more housing issues are referred to finance, in the Finance Committee.

Mr. Chairman, we have already acted on the companion bill, S. 1821, in the Housing Committee, and hopefully we will get favorable action from the Finance Committee, and we can proceed to enact this legislation that I think will be a great stimulus and indeed will open the door to private sector participation in the secondary mortgage market, to make more funds available to housing and to reduce financing costs to those who would be homeowners.

Thank you very much, Mr. Chairman.

Senator DANFORTH. Thank you, Senator Tower.

[Senator Tower's prepared statement follows:]

Senator Tower's Statement

Mr. Chairman, I want to thank you, and commend you, for holding these hearings on S.1822 and other issues affecting the secondary mortgage market.

I first learned about TIMs - an acronym for Trusts for Investment in Mortgages - from Shannon Fairbanks then a member of the White House staff when I was preparing for a G. E. housing conference last spring. The Administration has researched this proposal long and hard, and for many, many months we heard that - at any moment - the TIMs concept would be hardened into a legislative proposal and sent to the Congress. Unfortunately, the Administration's TIMs legislation was not available by the time we were ready to introduce our secondary mortgage market bills in August. Because both S.1821, now 2496, and S.1822 are complementary, and both bills embody recommendations made by the President's Commission on Housing for mortgage backed securities, we decided to introduce our own TIMs bill to start the legislative process. I guess it worked! - I understand that the Administration will describe their TIMs proposal today, and will send it to the Hill next week. The Administration's active participation in these discussions before Congress is welcomed and long awaited. I welcome them and look forward to their testimony. S.1822, of course, was our best guess concerning how a TIM would look and operate, and I will be the first to admit that, regarding the fine technicalities of the tax law, it is far from perfect.

The TIMs concept began as a recommendation by the President's Commission on Housing. That Commission, after thorough and comprehensive research by some of the leading authorities in the housing industry, pointed out that "mortgage related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory and tax standpoint in their competition with corporate debt obligations, unless the securities are covered by the guarantee of a Federal or federally related agency." Most of the Commission's proposals for changes in the banking and securities laws or regulations have been effected by the appropriate regulatory agencies, or by the changes contained in S.1821 - which earlier this week was reported out of the Banking Committee.

The Commission also recommended changes in the tax code. Specifically, it found that:

> The Internal Revenue Code should be amended to provide an exemption for conventional mortgage backed securities from taxation at the pool/issuer level, provided these securities meet minimum criteria. The Internal Revenue Code should also be amended to treat the recovery of market discounts on conventional mortgage backed securities on the same basis as such discounts are treated on corporate securities.

The tax changes are required to ensure that private entities can design a mortgage backed security that is more competitive and more attractive to capital investors than traditional mortgage "pass-through" securities. The tax code

problem essentially involves the rigidity of the grantor trust provisions of the Internal Revenue Code. Most mortgage backed securities on the market today are "pass-through" securities which utilize the grantor trust structure. To create a "pass-through", many mortgages are bundled together and placed in a "pool" or - for tax purposes - a "grantor trust". Shares are sold on the pool. The cash flow arising from the monthly payment of the mortgages in the pool is then "passed through" on a monthly basis to the shareholders. The purpose of the grantor trust mechanism is to avoid double taxation by providing for no taxation at the pool level - only at the shareholder level. However, the grantor trust rules are very strict, essentially permitting minimal, passive management of the trust to ensure the pass through to the shareholders of principle and interest payments on the mortgages. This inability to have more active management of the pool causes the following problems for creating mortgage backed securities attractive to many investors:

First, there is no call protection

Unlike a 12 year bond, which an investor knows will not be "called" or paid off until the end of the 12 years, a mortgage backed security may be paid off if the underlying mortgages are pre-paid by the mortgagee. Investors can't predict the duration of the investment. Under the grantor-trust rules, the trustee must pass through the prepayments of mortgages. However, under the TIMs proposal, if the trustee could more actively manage the pool, prepayments of mortgages could be held back, reinvested and distributed to the investor at the agreed upon maturity.

Second, there is pass-through of payments every month

Most investors are geared to receiving semi-annual payments -- on bonds, for instance. Pass-through securities must pass on the monthly payments of home owners on a monthly basis to investors. Under TIMs, the manager of the grantor trust could hold back the monthly principle and interest payments at the pool level and make investor payments less frequently.

Finally, there is only one class of securities

In general, each shareholder of a pass-through receives a pro-rata share of all funds available to the pool. A TIMs could be structured to issue two or more classes of securities with different characteristics to meet different investor needs. For example, the securities could be issued in three classes of 2 1/2 yrs, 5 yrs, and 12 yrs.

As the President's Commission pointed out, these disadvantages appear to be largely inadvertant consequences of past policy decisions. In our research on the changes needed to develop broad and active markets for conventional mortgage backed securities, we have found time and time again that the securities laws, the banking statutes, and various regulatory proclamations which now apply to mortgage backed securities were promulgated when these securities did not exist. The principles set forth in the current grantor trust provisions of the tax law are no different - they were fashioned when mortgage backed securities were not even a gleam in anyone's eye.

It is time to change the tax law and recognize the unique nature of the mortgage finance system today, and the increasingly important role mortgage backed securities will play in that system. I believe that as a matter of good public policy, the impediments faced by mortgage backed securities should be removed. That is why we introduced S.1821 and S.1822, and why I am here today. Specifically, I conclude that there are several good reasons for passing the TIMs tax proposals:

First, TIMs securities will enable private entities to create more competitive mortgage backed securities much more attractive to investors. The enhanced features of the pass-through security created through enactment of the TIMs proposals should appeal to a wide range of diversified investors who have never invested in mortgage backed securities, -- like foreign investors, or to investors who now place small percentages of funds in mortgages, -- like pension funds. As the President's Commission points out, the housing market would be greatly stimulated if pension funds were to invest greater percentages of their funds in mortgages.

Second, TIMs securities will encourage the entry and growth of private businesses into the secondary mortgage market. Existing regulatory and tax provisions amount to "barriers to entry" for private market competition, especially given the competition with federally sponsored agencies. The changes effected by S.1821, and S.1822, will remove many of these barriers and facilitate private market mortgage participation and growth. Growth of the private sector is essential to

supplement the agencies' contribution. Estimates show that the secondary market will become the primary source of mortgage capital over the next ten years -- a growth of over $200 billion per year. Public policy must dictate a sharing of the expansion of this capital need, as the federally sponsored agencies cannot possibly shoulder this increase in capital alone.

Third, private secondary mortgage market participants, armed with enhanced pass-through securities, should be able to better provide some needed competition with the federally sponsored agencies. That competition now heavily favors the agencies, with their ability to raise capital at agency costs, to use streamlined regulatory exemptions and nationwide marketing capacities. These advantages, not surprisingly, translate directly into almost total dominance by the federally sponsored agencies of those markets for loans they can purchase.

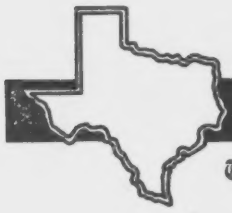
Furthermore, now is the time to help the private sector. The agencies have moved aggressively into the mortgage backed securities market. The Federal Home Loan Mortgage Corporation's pass-through program has experienced spectacular growth in the last few years. Freddi Mac issued $29 billion in securities by 1979, and over $61 billion by 1982. Brother Fannie Mae, which only recently had no mortgage backed securities program, has so far issued almost $26 billion in mortgage backed securities. Ginnie Mae, the pioneer for mortgage securities, has a whopping $114 billion in mortgage backed securities outstanding of $135 billion issued from the program's inception.

The mortgage backed securities market needs private as well as federal, participation. The tools provided by S.1821 and S.1822 are necessary to help private entrants compete with their powerful federal counterparts.

Finally, and most importantly, the TIMs structure will provide a potent economic tool to private entities to significantly lower financing costs to homebuyers. By removing costly barriers and inefficiencies in the securitization of mortgages, it has been estimated that a TIM's like securities can lower mortgage financing costs by 50 to 100 basis points. Dick Pratt of Merrill Lynch stated that a reduction of even 12 basis points would be the equivalent of writing a check to the homebuyer for 1% of the loan amount.

I want to commend the distinguished Chairman for convening these hearings. Mortgage Revenue Bonds, my MRA concept, the condominium cost reduction act and now TIMs all involve modification to the tax code, which in turn are major items in the national housing policy. The Finance Committee and the Banking Committee must increasingly work hard together as more and more housing issues are referred to Finance.

I would like to insert for the record an article entitled "2 Bills Seek to Widen Money Pipeline to Home Buyers" by Ken Harney.



John Tower in Print

The Washington Post

Saturday, August 20, 1983

2 Bills Seek to Widen Money Pipeline to Home Buyers

By Kenneth R. Harney

Two long-awaited pieces of legislation that could expand significantly the amount of mortgage money available to American consumers and cut the cost of home loans have been introduced on Capitol Hill.

Sponsored by the Senate's two top-ranking committee chairmen on banking and housing issues, the bills signal the start of a major congressional effort to widen the money pipeline between home buyers and Wall Street.

Here's what the proposals by Sens. Jake Garn (R-Utah) and John Tower (R-Tex.) would do, and how they could directly affect you as a buyer or seller:

• Remove most of the obstacles that discourage pension funds, insurance companies and others from investing in ordinary home mortgages.

THE NATION'S HOUSING

• Encourage more private firms to go into head-to-head competition with the two government-chartered corporations that have dominated American home financing since the early 1970s, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac). Both corporations buy individual loans originated by local lenders in vast quantities. Fannie Mae, for instance, owns $70 billion worth of mortgages—roughly one of every 20 home loans in the country.

• Encourage more diversity in the types of mortgages available in the marketplace. Large pools of home loans carrying innovative terms favorable to consumers—but not usually acceptable to large-scale investors—could be packaged and sold to Wall Street under the bills.

• Cut the going rate of home mortgages for future buyers by increasing competition within the market and turning on more "money spigots," in the words of one supporter of the bills. Rates on home loans could be sliced by anywhere between one-half and two percentage points, "simply by making mortgages as attractive and convenient as any other type of competing investment" available to an insurance company or other large owner of capital, he said.

The two new bills carry technical-sounding names that would make most consumers' eyes glaze over: the Trust for Investment in Mortgages Act of 1983 (S. 1822) and the Secondary Mortgage Market Enhancement Act of 1983 (S. 1821).

But stripped to their core, the proposals seek to make very basic, bread-and-butter changes in the business of financing homes. The technical amendments that the bills would apply to existing federal law will allow creation and sale of far greater numbers and varieties of what are known as "mortgage-backed securities." These are pools of hundreds of thousands of loans, packaged into bond-like securities that large capital investors can buy for income.

To picture how these work, imagine that the new mortgages made by banks on all the houses in your city or neighborhood this year were gathered together. The

See HARNEY, E5, Col. 1

Supply of Mortgage Money Could Grow

HARNEY, From E1

regular monthly payments coming in would make an attractive income—one not only secured by real estate, but carrying a higher return than money-market funds and corporate notes and bonds.

Now let's say those mortgage contracts were put into a package that provided payments on whatever schedule you as an investor wanted: once a year, twice a year, quarterly or monthly. Let's say also that all of the potentially sticky features of individual mortgages were guaranteed to be kept out of your hair: defaults, prepayments, foreclosures and the like.

You could buy into this pool of loans by purchasing a certificate—like a stock or bond—and be relatively certain you'd get the steady return you bargained for. You could buy the entire pool, for that matter, if you had enough bucks. Local lenders would make the mortgages, sell them into pools, and continue to service them indefinitely for a fee.

Although it comes as a surprise to some consumers, this is how more than half of all American home mortgages are financed today. The two new bills on Capitol Hill would speed the movement toward "wholesale" financing even faster. They would give the companies that put together wholesale packages additional powers to manage the cash flows on the loans in the pools. They also probably would stimulate creation of dozens of specialized competitors to Fannie Mae and Freddie Mac such as the new Residential Funding Corp. (RFC) of Minneapolis.

RFC—first previewed in this column last December—specializes in buying so-called "jumbo" home loans above $108,300 and 15-year mortgages. In its first seven months, RFC has committed to finance $1.5 billion worth of jumbo and other loans—mainly the types of mortgages that Fannie Mae and Freddie Mac can't or won't touch because of regulatory restrictions.

"The key here is "to open up the mortgage business to even more competition," said a staff aide on the Senate Banking Committee. "I mean, let's let a thousand flowers bloom. That will mean greater choices for more buyers—and who's going to beef about that?" Garn and Tower learn the answer to that question on Sept. 21, when they hold two days of hearings on their proposals.

Senator DANFORTH. Who would like to be next?

STATEMENT OF HON. JAKE GARN, U.S. SENATOR FROM THE STATE OF UTAH

Senator GARN. Mr. Chairman, let me emphasize what Senator Tower has just said: A lot of people seem to forget that the Banking Committee is not just banks and savings and loans; it is the Banking, Housing, and Urban Affairs Committee. So obviously we not only have responsibility, but great interest in the housing needs of this country.

When Senator Tower and I introduced this package, we quickly understood that part of it was under our jurisdiction. We have acted upon S. 1821 and sent it to the floor; but we consistently find that our jurisdiction does not extend to the tax aspects of these proposals. That's why you see a Banking Committee, Banking-Housing Committee, lineup here this morning, testifying on behalf of a proposal that fits with the things that we are doing in our authorizing jurisdiction.

I want to commend the Finance Committee for holding these hearings on S. 1822. I am a cosponsor of this bill, and I favor changing the tax laws to allow for the creation of mortgage-backed securities which are more attractive to capital investors and competitive with comparable corporate securities and agency issues.

Senator Tower has addressed the "trees" in this legislation—specific problems encountered with the grantor-trust provisions of the Internal Revenue Code—I will confine my remarks to a few comments about the "forest."

The first point I want to make is that the demand for housing credit is expected to be strong and to increase significantly throughout the 1980's. Demand for housing credit, of course, is dependent on a variety of factors, including interest rates, demographics, and social trends. But forecasters, using conservative estimates, have predicted that the demand for mortgage originations will exceed $200 billion annually for the 1980's. By comparison, the average annual mortgage originations have covered nearly $100 billion for 1981 and 1982. So we expect a doubling for the rest of this decade.

My second point is that this demand will increasingly be filled by secondary mortgage market activity, because the traditional institutional framework responsible for supplying mortgage funds in the past years has been altered. Of all financial activities, mortgage finance activities have been affected most by the dramatic changes undergone by this Nation's financial system during the past few years. Like the financial services markets in general, the primary and now the secondary mortgage markets are in a period of transition. Thrift institutions, the most important providers of housing funds in the past, have been rejuvenated with the aid of enhanced investment authorities—capital assistance and, of course, and most important, lower interest rates. In the process, they are changing their portfolio policies and are slowly abandoning the borrow-short, lend-long policies which endangered their stability in the volatile interest rate environment of the 1970's. They are be-

coming more active portfolio managers of more flexible and variable assets.

I fully believe that thrift institutions will stick to their knitting and continue as active participants in the loan-origination market. However, rather than holding long-term loans in portfolio, the evidence indicates that thrifts and other mortgage lenders are increasingly selling the loans they originate.

For example, 10 years ago only 24 percent of all loans originated were sold in the secondary mortgage market. That figure jumped to 58 percent for 1982, and the president of Fannie Mae recently announced that a whopping 65 percent of all single-family loans originated were sold into the secondary market. Like it or not, the secondary mortgage market has been thrust into the limelight following deregulation of the primary mortgage market.

My third point is that the secondary mortgage market, whether private or agency, will act as a conduit and increasingly utilize mortgage-backed securities as a device to most successfully access the capital markets. This is presaged by Fannie Mae and Freddie Mac's recent dramatic increase in the issuance of passthrough securities. These instruments have an increasingly important role to play. Now is the time to pursue and enact deregulatory initiatives so that an enhanced, more attractive mortgage-backed security can better play that role.

TIM's is a tool suited to the transition period we have entered in the primary and secondary mortgage markets, and it embodies proposals designed to accomplish another important objective: the entrance, growth, and active participation of private sector participants.

The objective of S. 1821 and S. 1822 could be characterized as "search and destroy legislation," because our intent has been to find and remove those obstacles in the tax, banking, and securities laws which stand in the way of creating a competitive passthrough security for private sector participants.

Our question all along has been, how do we facilitate a privately managed secondary mortgage market, given such powerful competitors as Fannie Mae, Freddie Mac, and Ginnie Mae? The answer suggested by TIM's is, don't bother to compete with the agencies on the basis of price; compete with them with a better product, a better mortgage-backed security.

It is our hope that the private market can establish itself and grow sufficiently strong on the basis of its products to compete with the Federal agency market.

Finally, Mr. Chairman, I would like to comment on the participation of Fannie Mae and Freddie Mac in TIM's. As I have made clear, a major purpose of TIM's is to facilitate the growth of private entities in the secondary mortgage market. S. 1822 would not permit these federally sponsored agencies to issue TIM's, and before supporting their participation I would have to be assured that it would not jeopardize private secondary market activity.

Again, we appreciate very much your efforts on this issue and for convening the hearing today. I concur with Senator Tower's remarks that the Banking Committee and the Finance Committee must increasingly work together on issues of mutual jurisdictional interest to both committees.

Mr. Chairman, I would ask unanimous consent that a statement by the American Council of Life Insurance, representing 591 life insurance company members, which strongly supports Senate bills No. 1821 and No. 1822, be included in the record.

Thank you very much.

Senator DANFORTH. Thank you.

[Senator Garn's prepared statement, and the letter from the American Council of Life Insurance follow:]

Statement of Senator Garn

Mr. Chairman, I also want to commend you for holding these hearings on S.1822.

I am a cosponsor of this bill, and I favor changing the tax laws to allow for the creation of a mortgage backed security which is more attractive to capital investors, and competitive with comparable corporate securities and agency issues.

Senator Tower has addressed the "trees" in this legislation - the specific problems encountered with the grantor trust provisions of the Internal Revenue Code. I will confine my remarks to a few comments about the forest.

The first point I want to make is that the demand for housing credit is expected to be strong, and to increase significantly throughout the 1980's. The demand for housing credit, of course, is dependent on a variety of factors, including interest rates, demographics, and social trends. But forecasters, using conservative estimates, have predicted that the demand for mortgage originations will exceed $200 billion annually for the 1980's. By comparison, the average annual mortgage originations have hovered near $100 billion for 1981 and 1982.

My second point is that this demand will increasingly be filled by secondary mortgage market activity, because the traditional institutional framework responsible for supplying mortgage funds in past years has been altered. Of all financial activities, mortgage finance activities have been affected most by the dramatic changes undergone by this nation's financial system during the past few years. Like the financial services markets in general, the primary, and now the secondary mortgage

31-489 O—84——3

markets are in a period of transition. Thrift institutions, the most important providers of housing funds in the past, have been rejuvenated, with the aid of enhanced investment authorities, capital assistance, and of course, lower interest rates. In the process, they are changing their portfolio policies and are slowly abandoning the borrow-short/lend-long policies which endangered their stability in the volatile interest rate environment of the 1970's. They are becoming more active portfolio managers of more flexible and variable assets. I fully believe that thrift institutions will stick to their knitting, and continue as active participants in the loan origination market.

However, rather than holding long term loans in portfolio, the evidence indicates that thrifts and other mortgage lenders are increasingly selling the loans they originate. For example, ten years ago, only 24 percent of all loans originated were sold into the secondary mortgage market. That figure jumped to 58% for 1982, and the President of Fannie Mae recently announced that a whopping 65% of all single family loans originated were sold into the secondary market. Like it or not, the secondary mortgage market has been thrust into the limelight following deregulation of the primary mortgage market.

My third point is that the secondary mortgage market, whether private or agency, will act as a conduit and increasingly utilize mortgage backed securities as a device to most successfully access the capital markets. As presaged by Fannie Mae and FreddieMac's recent dramatic increase in the issuance of pass-through securities, these instruments have an increasingly important role to play. Now is the time to pursue and enact

deregulatory initiatives so that an enhanced, more attractive mortgage backed security can better play that role.

TIMs is a tool suited to the transition period we have entered in the primary and secondary mortgage markets, and it embodies proposals designed to accomplish another important objective - the entrance, growth and active participation of private sector participants. The objective of S.1821 and S.1822 could be characterized as "search and destroy" legislation - because our intent has been to find and remove those obstacles in the tax, banking and securities laws which stand in the way of creating a competitive pass-through security for private sector participants. Our question, all along, has been "how do we facilitate a privately managed secondary mortgage market, given such powerful competitors as Fannie Mae, FreddieMac and Ginnie Mae?" The answer suggested by TIMs is "don't bother to compete with the agencies on the basis of price - compete with them with a better product, a better mortgage backed security." It is our hope that the private market can establish itself, and grow sufficiently strong on the basis of its products to compete with the federal agency market.

Finally, Mr. Chairman, I would like to comment on the participation of Fannie Mae and FreddieMac in TIMs. As I have made clear, a major purpose of TIMs is to facilitate the growth of private entities in the secondary mortgage market. S.1822 would not permit these federally sponsored agencies to issue TIMs, and before supporting their participation, I would have to be assured that it would not jeopardize private secondary market activity.

Again, we appreciate your efforts on this issue, and for convening the hearing today. I concur with Senator Tower's remarks that the Banking Committee and the Finance Committee must increasingly work together on issues of mutual jurisdictional interest to both Committees.

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4300

Richard S. Schweiker
President

November 3, 1983

The Honorable Jake Garn
Chairman
Senate Committee on Banking, Housing,
and Urban Affairs
534 Dirksen Senate Office Building
First and C Streets, N.E.
Washington, D.C. 20510

Re: Senate Bills No. 1821 and 1822

Dear Senator:

The American Council of Life Insurance, on behalf of its 591 life insurance company members, strongly supports Senate Bills No. 1821 and 1822 regarding mortgage-backed securities. As one of the principal investors in mortgages and mortgage-backed securities in the United States economy, the members of the Council are particularly interested in this legislation.

Life insurance company mortgage holdings at year-end 1982 amounted to approximately $142.0 billion. Preliminary data indicates that life insurance companies acquired a total of $11.5 billion in mortgages during 1982. Life insurance companies are also substantial investors in the mortgage-backed securities market.

While this participation in the mortgage market is significant by any measure and makes the life insurance industry one of the largest investors in mortgages and mortgage-backed securities, the relative percentage of life insurance company assets invested in mortgages has declined from 38.6% of life insurance company assets in 1966 to approximately 24.1% of life insurance company assets in 1983. Similarly, life insurance company participation in the home mortgage markets has declined. At the end of 1982, one-to-four family housing accounted for 11.7% of total mortgages held by life insurance companies on U. S. properties, compared with 28.8% at the end of 1972 and 56% at year-end 1962. The relative decline of life insurance company participation in the mortgage markets reflects a number of factors, not the least of which is the concern of life insurance companies that mortgages do not share the flexibility and liquidity of other investments.

It is our strong belief that S. 1821, by eliminating regulatory factors that detract from the ability of mortgage-backed securities to

compete with other investments will increase the interest of insurance companies in mortgage investing and in participation in the mortgage-backed securities markets. We are convinced that S. 1822, by establishing the "trust for investment in mortgages" ("TIM") and by permitting active management of the assets thereof, will make mortgage-backed securities a more attractive investment for institutions such as insurance companies. Also, we feel that the TIM concept can significantly expand the potential market for mortgage-backed securities by making such securities more attractive and predictable investments for individuals and investors other than large institutions. This will add important breadth and depth to the market for these securities.

For these reasons the Council supports passage of S. 1821 and 1822.

Sincerely,

Richard S. Schweiker

Senator DANFORTH. Senator Proxmire.

STATEMENT OF HON. WILLIAM PROXMIRE, U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator PROXMIRE. Thank you, Mr. Chairman.

I, too, am very grateful to you and to Senator Dole, the chairman of the committee, for permitting us to testify on this legislation. It was originated by Senator Tower, and Senator Garn introduced it. As soon as I heard about it I wanted to get on board, because I think it is the kind of legislation that can be extremely helpful to housing, and it has some very, very attractive features.

It can lower the cost of credit to millions of American buyers by as much as 1 percentage point. That could save a typical borrower as much as $25,000 over the life of a 30-year mortgage. At the same time, the legislation will not cost the U.S. Treasury a single penny in lost revenue.

Now, I know that you have heard this very often on a lot of legislation, and I hope that you will examine that claim very carefully; but I think that this will stand up. I think that in this case you will find that this is true.

Now, the reason we can reduce interest rates without costing the Federal Treasury is that we are improving the efficiency of the market; that is, we are making it possible for private sector firms to transform a mortgage loan into a bond-type instrument that is more attractive to large institutional investors. That gives it liquidity; that gives it a diversification, which means that the risk you have if you accept a mortgage, as our savings and loans do, is greatly diminished; investors can get an instrument more suitable to their needs if they are willing to accept a lower rate; the savings are passed on to the home buyer in the form of lower mortgage interest rates, and it is as simple as that.

The leaders of our housing and finance industries have told me that S. 1822, the Trust for Investment and Mortgage Act, can make a significant contribution to housing in our nation.

Senator Garn has already indicated that the demand for housing will be high throughout the decade, and we have documentation in my statement here to support that. As a matter of fact, we will need $1.6 trillion to finance home purchases and improvements through 1990—that's more than the national debt, if that makes you feel any better. [Laughter.]

They foresee an enormous mortgage credit gap facing the Nation unless we take some steps to close it.

The problem of mortgage credit supply rises from the dramatic changes that have taken place in our financial markets in recent years. Both the institutions which have traditionally loaned mortgage money to home buyers and the traditional mortgage debt vehicle, which transported capital to housing markets, have been undergoing drastic alteration. We haven't yet seen all the changes.

We have already witnessed the emergence of the secondary mortgage market. Twenty years ago, most home buyers got their mortgages from the thrift institutions which originated them. Today, investors who do not originate mortgages supply more than half of the Nation's mortgage credit. As a matter of fact, analysts project

that the secondary market investors will be called upon to supply 75 percent of the Nation's mortgage credit, an estimated $1.2 trillion, during this decade.

Leaders of the housing and finance industry are not sanguine about the capacity of today's secondary market institutions to satisfy projected needs. They see a clear need to expand the secondary mortgage market—and that's what this legislation would do—which today is almost totally dominated by three agencies which are Government or Government-related.

Financial leaders believe that expansion of the private secondary market would serve to broaden housing access to capital and, through product and price competition, help reduce the cost of financing the purchase of a home. They believe we would shortly see entry into the secondary mortgage market by private companies and the development of a strong and efficient private sector secondary market to complement and compete with the Government-supported giants now in the field.

The best hope for expanding secondary mortgage markets and increasing capital flows into housing is widely believed is through expanding the use of a new type of security, the mortgage-backed security. This type of issue, which is backed by residential mortgages which are pooled for investment purposes, is of very recent origin. Ginnie Mae pioneered the first passthrough mortgage security in the seventies. Their success in attracting capital is indicated by the fact that today there are $160 billion in outstanding Ginnie Mae securities, backed by mortgages which are insured or guaranteed by FHA or VA. There are, moreover, over $60 billion in securities issued by Fannie Mae or Freddie Mac based on pools of conventional mortgages. In a matter of a few years, mortgage-backed securities have distributed more than $200 billion in mortgage debt, a significant part of the total $1.7 trillion in U.S. mortgage debt outstanding.

Now, while Government-related agencies were successfully introducing securities backed by mortgages, private issues of mortgage-backed securities have been very modest in scale. That's what we want to beef up. There is an estimated little more than $10 billion in such securities today.

Now, why do private-sector issues lag when industry leaders believe that private mortgate investors could make inroads in capital markets with mortgage-backed securities? The answer, according to the President's Commission on Housing, lies in restrictive laws and regulations which govern the securities, banking, and tax areas. These restrictions, I submit, exist largely because existing laws and rules were established before mortgage-backed securities were created. The laws and rules simply were not designed with them in mind.

The sponsors of this legislation are supporting several efforts to remove restrictions which have been identified. S. 1821, the Secondary Mortgage Enhancement Act, approved several weeks ago by the Banking Committee, will make needed changes in our securities and banking laws. In the words of one witness, "The bill will improve the ability of the private issuers of the mortgage-backed securities to do business." The Banking Committee has acted on that, and has reported it. But the really crucial bill, in the judg-

ment of most experts, is the bill that is before the Finance Committee, the bill that you are going to act on, we hope. That is the key to enable us to develop competitively priced mortgages which could save the home buyer a very pretty penny.

S. 1822, commonly called "the TIM's bill" would amend the Internal Revenue Code to establish a new trust category that recognizes the unique character of the mortgage asset. A new section of the code would authorize and set guidelines for establishing a new trust which would be empowered to issue mortgage-backed securities.

This legislation would authorize mortgage investment trust to be an active manager of the mortgages pooled under the trust, rather than a passive manager of mortgages pooled under a grantor-trust, as presently required under the code. By permitting a TIM to be an active manager, this legislation, No. 1, provides call protection for investors by permitting the trustee to retain repayment of principal and defer payment to stock owners. Under the present code a trustee must, as a grantor-trust, regularly pass through all repayments, and as a result is unable to protect an investor from the uncertainty of an early repayment of the mortgage on which the security is based.

No. 2, it authorizes the issue of several classes of securities, each with its own characteristic which has been tailored to meet the needs of different investors. Under the present code, a grantor-trust can have only one class of security, and accordinaly has no ability to schedule repayments to shareholders on a different basis.

No. 3, it authorizes creation of bond-like investments with a schedule of semiannual payments of interest and principal, similar to arrangements made with investors under the existing code.

No. 4, it approves the use of interim assets as collateral to issue securities, and within a required 18 months will replace these assets with mortgages. Under the present code there is no similar authority given to a grantor-trust to utilize the assets of the trust.

At present, the Internal Revenue Code imposes double taxation on mortgage-backed securities—on the pool, as well as on the investor—unless the pool qualifies as a grantor-trust. But as we have seen, the grantor-trust status, by not permitting active management of the mortgage pool, is disadvantaged in being unable to provide investors with protection from early repayment or the trust itself security from changes in the interest rate.

In order to permit MBS's to compete effectively in today's capital market, this legislation would enable private MBS issuers to legally claim both the exemption from double taxation they have held and the capacity for actively managing its trust, which they need.

Finally, S. 1822, in establishing the TIM, seeks to amend the Internal Revenue Code in order to recognize in that law the unique characteristics of the mortgage-backed security. Leaders of the housing industry believe that TIM's can play a significant role in making homeownership available and affordable to more Americans, and in proposing this bill the sponsors also think it is time for TIM's, and we urge the committee to act favorably on the bill, and also, I am sure, to modify it. After all, the authors of the bill are not experts on taxation—you are. And we would welcome any

changes that you make that would insure that there wouldn't be any losses to the Treasury.

Senator DANFORTH. Gentlemen, thank you very much.

[Senator Proxmire's prepared statement follows:]

STATEMENT OF SENATOR WILLIAM PROXMIRE BEFORE THE COMMITTEE ON FINANCE ON S. 1822 TRUST FOR INVESTMENT MORTGAGES ACT

Mr. Chairman: I am pleased to join Senator Garn and Senator Tower in sponsoring S. 1822 and in testifying today in strong support of the legislation. This bill can lower the cost of credit to millions of American homebuyers by as much as one percentage point. This could save a typical borrower as much as $25,000 over the life of a 30 year mortgage. At the same time, the legislation will not cost the U.S. Treasury a single penny in lost revenue.

This sounds almost too good to be true. We have all heard similar claims before about changes in the tax laws. Usually on close examination, they turn out not to be accurate. But in this case, I believe they are.

The reason why we can reduce interest rates without costing the Federal Treasury is that we are improving the efficiency of the market. That is, we are making it possible for private sector firms to transform a mortgage lien into a bond-type instrument that is more attractive to large institutional investors. Because investors get an instrument more suitable to their needs, they are willing to accept a lower rate. The savings are passed onto the homebuyer in the form of lower mortgage interest rates. It is as simple as that.

Leaders of our housing and finance industries have told us that S. 1822, The Trust for Investment in Mortgages Act, can make a significant contribution to housing in our nation.

They have reported that:

(1) The demand for housing will be high throughout the rest of this decade. The population group that buys most of the houses in this country (those aged 25–39 years) will increase by 13%, or more than 12 million persons, by 1990. The formation of new households also is expected to continue at very high levels. With reasonable recovery of the economy, these pressures will combine to keep the demand for housing high during the coming years.

(2) Construction of new housing is expected to increase over present levels. New housing starts have been unusually low for several years. Last year's low 1 million units was the worst in recent history. This year's modest recovery, should be followed, according to the forecasts, by high level production throughout the remainder of the decade.

(3) We will need $1.6 trillion to finance home purchases and improvements through 1990. (note that that's more than our national debt, if it'll make you feel any better). They foresee an enormous mortgage credit gap facing the nation—unless we take some steps to close it.

The problem of mortgage credit supply arises from the dramatic changes that have taken place in our financial markets recently. Both the institutions which have traditionally loaned mortgage money to homebuyers, and the traditional mortgage debt vehicles which transported capital to housing markets have been undergoing drastic alteration. We haven't yet seen all the changes. But we've already witnessed the emergence of the secondary mortgage market. Twenty years ago most homebuyers got their mortgages from the thrift institutions which originated them. Today, investors who don't originate mortgages supply more than half of the nation's mortgage credit. Analysts project that the secondary market investors will be called upon to supply 75 percent of the nation's mortgage credit—an estimated $1.2 trillion—during this decade.

Leaders of the housing finance industry are not sanguine about the capacity of today's secondary market institutions to satisfy projected credit needs. They see a clear need to expand the secondary mortgage market, which today is almost totally dominated by three agencies which are Government or Government-related. Financial leaders believe that expansion of the private secondary market would serve to broaden housing access to capital, and, through product and price competition, help reduce the cost of financing the purchase of a home. They believe we would shortly see tangible benefits from a public policy that encourages entry and development of a strong and efficient private sector secondary market, to complement and compete with the Government supported giants now in the field.

The best hope for expanding secondary mortgage markets and increasing capital flows into housing, it is widely believed, is through expanding the use of a new type

of security—the mortgage-backed security. This type of issue, which is backed by residential mortgages which are pooled for investment purposes, is of very recent origin. Ginnie Mae pioneered the first "pass through" mortgage security in the 1970's. Their success in attracting capital is indicated by the fact that there are today $160 billion in outstanding GNMA securities backed by mortgages which are insured or guaranteed by FHA or VA. There are moreover $60 billion in securities issued by FNMA or FHMC based on pools of conventional mortgages. In a matter of a few years, mortgage backed securities have distributed more than $200 billion in mortgage debt, a significant part of the total $1.7 trillion in U.S. mortgage debt outstanding.

While government related agencies were successfully introducing securities backed by mortgages, private issues of mortgage backed securities have been modest in scale. It is estimated that little more than $10 billion in such securities have been issued to date.

Why have private sector issues lagged, when industry leaders believe that private mortgage investors could make inroads in capital markets with mortgage backed securities?

The answer, according to the President's Commission on Housing lies in restrictive laws and regulations which govern the securities, banking and tax areas. These restrictions, I submit, exist largely because existing laws and rules were established before mortgage backed securities were created. The laws and rules simply were not designed with them in mind.

The sponsors of this legislation are supporting several efforts to remove the restrictions which have been identified. S. 1821, the Secondary Market Enhancement Act approved several weeks ago by the Banking Committee will make needed changes in our securities and banking laws. In the words of one witness, that bill will improve the ability of the private issuers of mortgage backed securities to do business. The bill before this Committee today, in his view, is the key that would enable him to develop a competitively-priced mortgage which could save the homebuyer a pretty penny.

S. 1822, commonly called the TIMs Bill would amend the Internal Revenue Code to establish a new trust category that recognizes the unique character of the mortgage asset. A new section of the Code would authorizie and set guidelines, issue mortgage backed securities. This legislation would authorize Mortgage Investment Trust to be an active manager of the mortgages pooled under the trust, rather than the passive manager of mortgages pooled under a Grantor Trust, as presently required under the Code.

By permitting a TIM to be an active manager, this legislation (1) provides call protection for investors by permitting the trustee to retain repayment of principal and defer payments to stock owners. Under the present code, a Trustee must, as A Grantor Trust, regularly pass through all repayments and as a result is unable to protect an investor from the uncertainty of an early repayment of the mortgage on which his security is based; (2) authorizes the issue of several classes of securities, each with its own characteristics which have been tailored to meet the needs of different investors. Under the present code, A Grantor Trust can have only one class of security, and accordingly has no ability to schedule repayments to shareholders on a different basis; (3) authorizes creation of bond-like investments with a schedule of semi-annual payments of interest and principal, similar to arrangements made with investors under the existing Code; (4) approves use of interim assets as collateral to issue securities and, within a required 18 months, replace these assets with mortgages. Under the present Code there is no similar authority given to a Grantor Trust to utilize the assets of the Trust.

At present, the Internal Revenue Code imposes double taxation on mortgage backed securities (on the pool as well as on the investor) unless the pool qualifies as a Grantor Trust. But as we have seen, the Grantor Trust status, by not permitting active management of the mortgage pool, is disadvantaged in being unable to provide investors with protection from early repayment, or the trust itself, security from changes in the interest rate.

In order to permit MBSs to compete effectively in today's capital markets, this legislation would enable private MBS issuers to legally claim both the exemption from taxation they have held, and the capacity for actively managing its trust, which they need.

S. 1822 in establishing the TIM seeks to amend the Internal Revenue Code in order to recognize in that law, the unique characteristics of the mortgage backed security.

Leaders of the housing industry believe that TIM can play a significant role in making homeownership available and affordable to more Americans.

In proposing this bill, the sponsors also think its time for TIM, and we urge the Committee to act favorably on this bill.

Senator DANFORTH. Senator Long.

Senator LONG. Well, let me just say to you three Senators that what you are testifying here sounds like a great idea. I must admit this all comes as news to me. I have never heard anything about this before you three presented your testimony.

While I think I would be for it, I really do think it would help if someone in presenting this matter to the Senators would get some big charts up, to illustrate rather simply how all of this works.

You know, in the Finance Committee some years ago we were handling those tariff bills. I told the staff that I wanted them to go get whatever it was we were talking about, like a Chinese gooseberry—"Go get one of those things so we can look at them, and pass it around so everybody can feel it and touch it." [Laughter.]

We'd be putting it in our mouth and biting on it, to see what it felt like to the mouth, to see what it is we are talking about in these situations.

Now, it sounds great to me; but may I say that I had to hear all three of you before I really began to see what this thing really is. It sounds like a great idea. But I would hope, before we vote this through the Senate, somebody could get some charts together and stand up and explain them to us.

Now, under existing law, you can't do this, although you can do it with some other kind of security. And what we want to do is fix it so you can do this and so you can do that, and so forth, because it all sounds a great idea.

If it's as good as it sounds from the presentations made by the three of you, then I'm a supporter.

Senator TOWER. Well, may I say, Senator, before you go to markup we'll have the charts available. [Laughter.]

Senator LONG. That would help.

Senator GARN. Senator Long, the Banking Committee will make available our expertise on the overall concept, and with your people work together on the technicalities of the Tax Code.

Senator LONG. You know, people construe that just because some fellow has a couple of college degrees that he knows a lot of things he might not know at all. And that's how it is in my case.

Senator PROXMIRE. I would welcome that very, very enthusiastically. I think that's right. And we have a lot of talent on the staff of the Banking Committee—we don't have any artists—but, mayb that's not a bad idea. We have had charts in the past, and they ce tainly greatly simplify and clarify my mind, and I think if there are defects in this proposal it would permit us to correct them.

Senator LONG. I didn't say there were any defects; I just said it would be nice if you could show in simple terms how all this works.

Senator DANFORTH. Well, Senator Long has made me feel good. I thought I was the only one sitting up here who didn't understand this. [Laughter.]

My reason is, I didn't know I was going to be here until 5 minutes before I showed up, when I was plucked off a street corner and brought to court here. [Laughter.]

But I think it sounds to me like it is a very good idea.

I am told that one of the few bones of contention has to do with whether or not to include Fannie Mae and Freddie Mac in any TIM's legislation. And your position is no, they should not be included; is that right?

Senator TOWER. Yes, because the thrust of this is to stimulate the private sector, and for my part, and I think there are others who agree with me, we should not authorize the Government sponsored agencies to issue TIM's at this time. Should they be authorized, I think, if Fannie Mae for example should be authorized to issue TIM's, it should serve the lower end of the income levels, or perhaps be used to assist them in reducing the quantity of underwater loans that they now have. That would be the only rationale I could see.

But at the moment, the thrust is to stimulate private sector participation in the secondary market. And I think this in no way has any adverse impact on the Fannie Mae or Freddie Mac.

Senator GARN. Mr. Chairman, let me just expand on that a little bit. The Banking Committee supports Freddie Mac, Fannie Mae, and Ginnie Mae. I think there should be no doubt left in anybody's mind about that. And we are in no way attempting to dilute what they presently do.

There has been some debate on whether we should increase the level of loans that they can purchase, which is now at $108,300. We do not intend to increase that limit. So the loan market we are primarily aiming at here is above that level. And believe me, if you look at the demographics and the figures over the next decade, there is all kinds of business for Freddie Mac and Fannie Mae over those years in that lower and middle market. And we are purposely intending to want to expand the secondary mortgage market for housing credit. This, as I indicated, is $100 to $200 billion annually. Freddie Mac and Fannie Mae simply cannot provide all of that. And we want the privatization to occur.

Now, there are some rumors going around, and those who favor these agencies have been worried about moving to privatization efforts by the administration.

I specifically wrote a letter on this to the Treasury in the last week and said, "Hey, back off. Leave it alone—at least for the present." So it is not the intent of the Banking Committee to infringe in those areas, but only to expand these markets into the higher areas and encourage the private sector to get involved because of the gigantic need that is going to occur over the next decade.

Senator PROXMIRE. Could I say, Mr. Chairman, I think the whole thrust of this legislation is to get the private sector involved.

As I pointed out in my statement, at the present time the Government agencies are doing practically everything. Only a tiny fraction, less than 4 or 5 percent, is in the private sector. What we would do is expand this greatly into the private sector, and I understand that Treasury feels the same way about it. So I think we are pretty much on all fours with it.

Senator DANFORTH. Thank you very much.

Senator TOWER. Thank you, Mr. Chairman and Senator Long.

Senator DANFORTH. Next is Robert G. Woodward, tax legislative counsel, Department of the Treasury.

STATEMENT OF ROBERT G. WOODWARD, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C., ACCOMPANIED BY ANDREW E. FURER, ATTORNEY ADVISOR, TREASURY DEPARTMENT

Mr. WOODWARD. Thank you, Mr. Chairman.

I am pleased to have the opportunity to pinch-hit for Assistant Secretary Chapoton in presenting the views of the administration on TIM's and other tax matters affecting the secondary mortgage market.

As you have heard, the secondary mortgage market is now dominated by the three Federal agencies with Federal credit backing—Fannie Mae, Freddie Mac, and Ginnie Mae.

Ninety-seven percent of the mortgage-backed securities purchased by investors in the secondary market during the first 8 months of 1983 were issued or backed by these Government-related agencies.

I would be happy, Senator Long, to go into painful detail as to how these are structured, but I think they are similar in concept, at any rate, to the real estate investment trust, a vehicle which you are familiar with, although they would be a total flowthrough tax vehicle rather than the more limited form provided by the real estate investment trust.

The 97-percent statistic indicates that the Federal involvement in the secondary market has expanded significantly as thrift institutions have shifted their focus toward origination and servicing of mortgages rather than holding mortgages they originate as long-term investments.

The administration believes that as a matter of Federal credit policy it is crucial to encourage the private sector mortgage securities issuers to enter the market as viable competitors of the Government-related agencies. The administration views the TIM's concept as a key tool for increasing the role of private sector issuers of mortgage-backed securities.

I might say that we view this as a role in the below-$108,000 mortgage market, as well as the so-called nonconforming, over-$108,000, mortgage market. We do not support TIM's legislation that would permit the Government-related agencies to use this new investment vehicle. The administration fully concurs with the sponsors of S. 1822 that the intent of the TIM's initiative is to foster a strong, totally private, secondary mortgage market.

The TIM's proposal, limited in this manner, should be viewed as a first step toward privatization of the secondary mortgage market. After the TIM's vehicle is in place, we will study the expansion of the private market and may propose further steps toward privatization of the secondary market, as may be appropriate.

I would like to comment on some specific aspects of S. 1822 and on the alternative TIM's proposal that the administration plans to present in the near future.

Under the provisions of S. 1822, a TIM—a Trust for Investment in Mortgages—could acquire a pool of mortgages. It would be exempt, itself, from corporate tax on the earnings of the pool, as in the case of fixed investment trusts, which are now the primary investment vehicle for the mortgage-backed securities. Those are

grantor trusts, taxed under longstanding rules developed in the trust area.

The tax incidence of owning mortgages generally would be unchanged from present law, and all tax liabilities associated with the direct ownership of the mortgages would be borne by the investors in the TIM. However, unlike a fixed investment trust, a TIM could actively manage its portfolio of assets so as to provide for call protection against unexpected prepayments. A major problem with the fixed investment trust vehicle is that the trustee must be prohibited from reinvesting any prepayments of the mortgages. If the trustee is not so prohibited, the trust could be treated as an association taxable as a corporation.

In addition, fast-pay, slow-pay interests in the mortgage pool would be permitted. This is a key feature of the TIM's concept and would result in a creation of a security that would be a more flexible investment vehicle than those offered through the traditional fixed investment trust.

The administration supports these general aspects of TIM's as proposed in S. 1822, which are consistent with the TIM's concept that was originally developed by the President's Commission on Housing. However, we do not believe that the bill contains adequate provisions to limit the TIM's vehicle to wholly private issuers. Our written statement goes into some detail about the additional steps we think should be taken in this regard, and the problems that we see in the bill as currently drafted We also point out some technical problems that would have to be resolved in order to create a properly functioning passthrough investment vehicle.

In the near future, as I have indicated, the administration will propose an alternative TIM's statute that does reflect our concerns. The goal of the rules that we will propose will be to allocate to TIM's stockholders the same amount and character of taxable income in the aggregate as would have arisen had the mortgages been held outside of the entity. When all TIM's shares are not identical, that is, when they are divided into serial maturity-type obligations, under our proposal the income would be allocated by looking first to the investors who are receiving priority cash distributions from the TIM, the so-called fast-pay interests, who get their money out of the pool first. Thus, the use of fast-pay, slow-pay classes of debt would be facilitated.

In addition to prohibiting direct or indirect use of TIM's by the Government-related agencies—Freddie Mac, Fannie Mae, and Ginnie Mae—the administration proposal will also contain other provisions designed to prohibit TIM's-like transactions using Government-related agency securities. These TIM's-like transactions, which are developing rapidly now, involve multiple-class partnerships, real estate investment trusts, and mortgage-backed bonds.

In addition, our proposal will deny the installment sale reporting method in connection with long-term builders bond arrangements that some taxpayers are using to circumvent the rules of current law relating to the disposition of installment obligations.

It is our hope that Congress will give the administration proposal serious consideration. We also are proposing in this connection that the current tax exemption accorded Freddie Mac be removed. We think that the reasons for that tax exemption, if they were ever

valid, certainly don't hold today. Fannie Mae is a taxable entity competing with the tax-exempt Freddie Mac. We think there is no reason for Freddie Mac to continue to enjoy the net competitive advantage that it does enjoy over Fannie Mae at the current time.

This concludes my remarks. I would be happy to answer any questions you may have.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 9:30 a.m., E.S.T.
November 4, 1983

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Administration on S. 1822, a bill to amend the Internal Revenue Code to create a new mortgage investment vehicle known as Trusts for Investments in Mortgages ("TIMs"). I also would like to take this opportunity to discuss generally the tax treatment of residential mortgage investments and secondary mortgage market institutions.

While the Administration opposes S. 1822 as presently drafted, the Administration does support the TIMs concept. The Administration plans to offer in the near future an alternative TIMs proposal for the Committee's consideration as a substitute for S. 1822.

31-489 O—84——4

Background

The secondary mortgage market has expanded dramatically in the last few years and is expected to continue to grow. The term "secondary mortgage market" describes a market where mortgage originators such as thrift institutions and mortgage bankers may sell mortgages or mortgage-backed securities to investors who desire to own them as portfolio investments. According to the Wall Street Journal, in 1980, mortgage orginators sold almost one-half of all single family residential mortgage originations in the secondary mortgage market. Many believe that sales of home loans in the secondary market will soon total two-thirds of all new mortgage originations. HUD estimates that nearly $116 billion of single-family mortgages were purchased in the secondary mortgage market during the first eight months of 1983. This eight-month volume for 1983 exceeds the record $110 billion volume for all of 1982 and is more than double the 1981 volume of $55 billion.

The rapid growth of the secondary market has coincided with a trend towards "securitization" of mortgages, that is, the packaging of large pools of mortgages into mortgage-backed securities that represent interests in the pooled mortgages. In the first eight months of 1983, an estimated $60 billion in mortgages were pooled into mortgage-backed securities and sold in the secondary market. Mortgage-backed securities have the advantage of greater liquidity and less risk of default than individual whole mortgages, and they free investors from the administrative burden of having to deal with thousands of relatively small mortgages which comprise the mortgage pool.

One of the principal reasons for the expansion of the secondary mortgage market has been the substantial change in the nature of thrift institutions, which traditionally have supplied the bulk of long-term residential mortgage credit. Since the late 1970's, thrifts have faced higher costs of capital as interest rates paid on deposits increased due to competitive pressures and interest rate deregulation of financial institutions. Volatile interest rates made it increasingly risky for thrifts to finance portfolios of long-term fixed rate mortgages with short-term deposits bearing variable interest rates. Many thrifts experienced substantial losses when their interest costs exceeded their returns on long-term fixed interest rate mortgage investments. Partly as a result of the problems faced by thrifts, thrift asset powers have been expanded through deregulatory legislation, with the result that thrifts now may own more non-mortgage assets in their portfolios. At present, thrifts increasingly have been shifting their focus towards origination and servicing of residential mortgages, rather than holding mortgages they originated as long-term investments.

The secondary mortgage market is the principal means by which thrifts and other mortgage originators are able to sell newly originated mortgages (or older mortgages held in their portfolios) to raise capital to finance new mortgage loans. At the present time, the secondary market is dominated by three agencies with ties to the Federal government: the Federal National Mortgage Association (FNMA or "Fannie Mae"), the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac"), and the Government National Mortgage Association (GNMA or "Ginnie Mae"). Ninety-seven percent of the mortgage-backed securities purchased by investors in the secondary market during the first eight months of 1983 were issued or backed by these Government-related agencies. As this statistic indicates, the Federal involvement in the secondary market has expanded significantly as the role of thrift institutions as investors in mortgages has decreased.

GNMA is part of the Department of Housing and Urban Development. It provides a secondary guarantee (backed by the full faith and credit of the United States) of FHA-insured or VA-guaranteed mortgage pools formed by qualified private issuers. FNMA is a privately owned corporation which has special Federal agency borrowing privileges (a $2.25 billion Treasury line of credit usable at Treasury discretion), as well other Federal agency benefits such as an exemption from securities registration requirements and from state and local taxes. FHLMC is wholly owned by the Federal Home Loan Banks, which in turn are owned by private thrift institutions. FHLMC has, among other Federal agency benefits, an indirect Treasury line of credit of $4 billion (through the Federal Home Loan Banks), also at Treasury discretion. Unlike FNMA, FHLMC is exempt from Federal income taxes. Because of their agency status and statutory privileges, FNMA and FHLMC are able to obtain capital at close to the borrowing rates applicable to Treasury borrowings. As of the end of fiscal year 1983, these agencies owned about $80 billion in mortgages and had over $223 billion in mortgage-backed securities outstanding.

Under present law, FNMA and FHLMC both are limited to acquiring "conforming" mortgages (i.e., those under $108,300). They may acquire these mortgages for their own portfolios, but increasingly they are purchasing mortgages to be packaged and resold as mortgage-backed securities guaranteed by their credit. Because of their agency status and standing in the markets, almost all mortgage-backed securities using conventional, conforming mortgages are sold by FNMA and FHLMC. In addition, almost all FHA or VA mortgages sold in the secondary market are sold with GNMA guarantees.

Within the past 12 months there have been some new wholly private concerns that have entered the secondary market as issuers of mortgage-backed securities. These private issuers are allowed to purchase any kind of mortgage to use for their mortgage-backed securities, but in fact they are often priced out of the Government-insured and conventional, conforming markets because of the presence of the Government-related agencies. The extent of their disadvantage may be estimated by comparing the interest rate spreads between mortgage-backed securities issued by private parties and those issued by FNMA and FHLMC. Compared to securities of private issuers, FNMA and FHLMC securities have a 50 to 100 basis point interest rate advantage that directly reflects their agency status. These private sector issuers are able to operate in the conventional, non-conforming (over $108,300) market without competition from the Government-related agencies. However, the nonconforming market is relatively small, accounting for less than 8 percent of mortgages sold in the secondary market.

Over the past two and a half years, the Administration has made a strong commitment to controlling the growth of Federal credit, including credit of Government-related agencies, for several reasons. First, the growing Federal consumption of capital that could be more efficiently employed if left in private hands has caused a misdirection of investment resources and has substantially inhibited capital formation and economic growth. Second, Federally subsidized borrowers are nearly always less productive than unsubsidized borrowers, in large part because this growing Federal intervention has distorted the market's assessment of true risk and return and weakened the normal bottom-line discipline of profitability and credit worthiness. Finally, the avalanche of new Federal and Federally sponsored debt issues continuously offered to the market will keep interest rates higher than would otherwise be the case, forcing all private firms to shoulder more expensive financing costs and in many cases crowding out unsubsidized private borrowers who cannot absorb the higher interest expense.

As part of this policy of limiting the growth of Federal credit, the Administration remains committed to seeking the total privatization of Fannie Mae and Freddie Mac. The Administration is convinced that the special advantages enjoyed by these agencies result in a less efficient allocation of this nation's scarce credit resources and higher overall borrowing costs for all users of credit, including many homebuyers. Although the Administration does not propose to privatize Fannie Mae and Freddie Mac at this time, the Administration believes that as a matter of Federal credit policy, it is crucial to encourage private sector mortgage securities issuers to enter the market as viable competitors of these agencies. As more fully discussed

below, the Administration views the TIMs tax proposal as a key tool for increasing the role of private sector issuers of mortgage-backed securities. The Administration will not support any TIMs tax legislation that permits the Government-related agencies to participate directly or indirectly in this new market. Thus, the Administration fully concurs with the sponsors of S. 1822 that the intent of the TIMs initiative is to foster a strong, totally private, secondary mortgage market.

The TIMs proposal, limited in this manner, should be viewed as a first step toward privatization of the secondary mortgage market. After the TIMs vehicle is in place, we will study the expansion of the private market and will propose further steps towards privatization of the secondary market as may be appropriate.

With that background, I will now turn to the current tax treatment of mortgages and mortgage-backed securities.

Tax Treatment of Mortgages and Mortgage-Backed Securities

Whole mortgages. Under current law, holders of debts of individuals (including residential mortgages) are subject to different rules from those applicable to holders of debt instruments of corporate debtors. Stated interest provided for in a loan obligation is ordinary income to the holder, regardless of whether the debtor is an individual or a corporation. However, the tax treatment of unstated interest, such as discounted "points", and the treatment of collections of principal on the loans differs depending on the identity of the debtor. Original issue discount on debt obligations of persons other than individuals is subject to the periodic inclusion rules of Code section 1232A, which require a portion of the original issue discount to be taken into the holder's income on a daily basis as interest income, whether or not received. In contrast, original issue discount is not taxable to the holder of an individual's mortgage loan until actually received or accrued (depending on the holder's method of accounting). Another important difference is that receipt of principal payments from the debtor in excess of the holder's basis in a corporate debt obligation results in capital gain to the holder (other than a financial institution) if the debt is a capital asset in the holder's hands. This capital gain may arise when an existing obligation that was issued for its face amount is purchased at a discount ("market discount"), and the debtor thereafter repays the obligation. See Code section 1232(a)(1). In contrast, the holder of an individual's mortgage obligation that was acquired at a market discount has ordinary income when the mortgage is repaid. Since there are many billions of dollars of existing mortgages with below-market interest rates, there is a tremendous amount of potential market discount on mortgages in our economy.

In the case of a mortgage purchased at a market discount, each payment of principal results in ordinary income to the extent that the amount of principal received (or due) exceeds a proportionate part of the holder's basis in the obligation. For example, if an investor buys a $100 mortgage for $80, each dollar of principal received from the borrower will result in 20 cents of ordinary income; 80 cents of the investor's basis will be offset against each dollar of principal received. Since residential mortgages generally call for low principal payments in early years and increasing principal payments in later years, the ordinary income attributable to a mortgage purchased with market discount tends to be deferred until later years.

Market discount is in all respects the equivalent of interest income to the holder of a debt because it exists in lieu of coupon interest, and is reflected in the fixed and predictable growth in value of the bond according to a compound interest formula. To treat market discount correctly, the holder of a debt acquired at a market discount should be required to include the discount in income annually on a constant interest method, similar to that applicable to corporate original issue discount obligations. We believe, however, that another approach which would be more easily administered and complied with by taxpayers might be adopted as an alternative. This alternative approach would require computation of the periodic accrual of market discount, and recognition of this amount as ordinary income when the bond is sold or paid at maturity. The computation of the accrual of market discount would be made on a straight-line basis or the constant interest method, at the taxpayer's election. Equivalent tax treatment should apply to market discount on both corporate and individual debts.

Mortgage-backed securities. Until recently, most residential mortgages marketed as mortgage-backed securities were not sold as whole mortgages, but were pooled in "fixed investment trusts" and sold in the form of certificates of beneficial interest in the trusts. The fixed investment trust form is used because no corporate or other income tax is imposed on the trust, which is viewed as a "grantor trust." In a grantor trust, all income taxes with respect to the mortgages are paid by the certificate holders under the rules applicable to direct ownership of whole mortgages, and the certificate holders are treated as the beneficial owners of the mortgages. Since the investors are considered to "own" mortgages rather than some other security, thrift institutions that own fixed investment trust mortgage securities may treat them as "mortgages" for purposes of the special bad debt reserve deduction available to thrifts with substantial mortgage investments. See, e.g., Rev. Rul. 70-544, 1970-2 C.B. 6; Rev. Rul. 70-545, 1970-2 C.B. 7.

The beneficial tax treatment of fixed investment trusts is lost if the trustee of the trust possesses any significant power to vary the investments of the trust (such as by reinvesting the proceeds of mortgages that are prepaid). If such a power exists, the trust is treated as an association taxable as a corporation, and a corporate tax will be imposed on the trust. Distributions by the trust to certificate holders then would be subject to a second tax as "dividends."

Despite its widespread use, the fixed investment trust device for mortgage investments has several drawbacks. The threat of association status makes it difficult to provide "call protection" to investors (i.e., a guaranteed yield for a guaranteed period), because unforeseen mortgage prepayments or other receipts of the trust cannot be reinvested in new mortgages. Since mortgage prepayments cannot be reinvested, they must be distributed to the investors. Investors are unable to predict with certainty the duration of their investments or their expected yields to maturity. Many investors have declined to purchase fixed investment trust mortgage-backed securities because of their lack of call protection.

In addition, it is difficult or impossible to structure a fixed investment trust when the certificate holders have interests in the mortgages that differ in their respective maturities or in their rights to receive distributions of cash flow. For example, it may be impossible in a fixed investment trust to provide for a priority in distribution of cash flows to certain investors. Such priority arrangements, known as "fast-pay, slow-pay" pools, are desirable as a means of providing investors call protection and a mortgage security with a more certain maturity. In a fast-pay, slow-pay pool, all mortgage principal payments (including prepayments) up to a specified amount are first distributed to a class of "fast-pay" investors who do not require call protection and wish to make short-term investments. After the fast-pay class has been retired, the remaining "slow-pay" classes begin to receive principal payments collected by the pool. The slow-pay investors have an investment with a longer maturity than fast-pay, and they enjoy some significant degree of call protection because their investment will not be retired until all fast pay investors have been fully repaid. Fast-pay, slow-pay pools partitioned into two or more investment classes may be sold at a significant premium over whole mortgage pools because of these features.

Other arrangements besides grantor trusts may be used to market mortgage-backed securities without a corporate tax being imposed on the pool. Issuers are beginning to turn to these alternative structures to avoid the limitations presented by the grantor trust rules. Although these arrangements allow active management of the mortgages in the pool and multiple classes of ownership, they pose a variety of problems of their own.

Real estate investment trusts (REITs) are permitted to pass through their income to shareholders without corporate tax. REITs may own residential mortgages, and they are permitted to exercise certain active management powers. REIT also may have more than one class of ownership interest. However, a REIT must have 100 or more shareholders, making it unavailable for use in private placements, and it must distribute at least 95 percent of its income and cannot reinvest those amounts. Although multiple class REITs are permitted, there is uncertainty regarding the taxation of the stockholders in a fast-pay, slow pay REIT because of the potential adverse application of Code section 305 and other Subchapter C rules as shares are periodically redeemed. Furthermore, the REIT rules change the character and timing of the income flow from the mortgage investments from that which would be available to direct investors in mortgages.

Partnerships also might be used as a means of marketing multiple classes of mortgage-backed securities without any corporate tax being imposed on the mortgage pool. However, partnerships are subject to a variety of complex rules under Subchapter K of the Code. Furthermore, partners are allowed to deduct on their individual returns tax losses sustained by the partnership, and are allowed to make special allocations of income and loss among themselves. We have some concern that partnerships that invest in mortgages might be used as a means of creating substantial tax shelters or tax-deferred interests for the benefit of certain partners. These tax avoidance possibilities are not available under the fixed investment trust vehicle. In addition, serious distortions of taxable income could result for a partner who acquires his interest in the partnership in the secondary market from an existing partner at a discount or premium, unless a series of adjustments is made by the partnership to the cost basis of each of its mortgages each time a partnership interest changes hands. These adjustments would be a burdensome endeavor in a publicly traded vehicle. Partnership investments also may not be legal investments for some classes of potential mortgage investors under State regulatory statutes.

Finally, mortgage-backed securities can be issued as corporate indebtedness that is secured by mortgages (or mortgage-backed securities) owned by the issuing corporation ("mortgage-backed bonds"). The bonds might pay to the holders all or most of the amounts received on the underlying mortgages. Since mortgage-backed bonds are corporate bonds, the tax treatment of the holders of the bonds and the issuer is governed by the rules applicable to corporate bonds, rather than to those applicable to mortgages of individuals. The disparity between these rules may in some cases make it disadvantageous for investors to acquire the bonds. On the other hand,

mortgage-backed bonds in some situations might be used to create tax shelters for issuers of the bonds. Furthermore, in some cases, recovery of market discount on the mortgages might be converted into capital gain in the hands of the bondholders.

One category of mortgage-backed bonds, known as "builders' bonds", also presents tax policy concerns. Builders' bonds are issued by home builders who sell houses under the installment sales method. The builders take back mortgages on the houses, and report their profits on the sales as principal payments are made on the mortgages. In a typical builders' bond transaction, the builder pools the mortgages and converts them into mortgage-backed securities carrying a GNMA or other agency guarantee. The guaranteed securities are then pledged as collateral for the mortgage-backed bond issue. The bonds enable the builder to borrow all or a substantial part of the amount of the mortgages, since they are backed by the Federal Government and produce sufficient revenues to service most or all of the payments due on the bonds. Thus, issuing a builders' bond enables the builder to receive almost the full value of the mortgages in cash without exposing itself to any significant borrowing risk, while at the same time continuing to defer tax on the profits from the sale of the houses for as long as 30 years.

Installment sales reporting is intended to benefit taxpayers who sell their property but do not promptly receive the full sales proceeds. With a builder's bond, however, the builder receives the sales proceeds when the bonds are sold to the investors. Because a purchaser of a builder's bond is unaffected by the limitations or restrictions on securities issued by fixed investment trusts, builders' bonds may be more attractive to investors than fixed investment trust mortgage securities.

S. 1822

Trusts for Investment in Mortgages

S. 1822 would create a new investment vehicle for mortgage-backed securities known as TIMs (Trusts for Investment in Mortgages). The Administration agrees with the sponsors of S. 1822 that a new mortgage-backed securities vehicle is needed to respond to the difficulties with existing structures for packaging mortgages for sale in the secondary market. However, the Administration has one significant policy objection with respect to S. 1822, and there are several important technical problems with the bill.

Under the provisions of S. 1822, a TIM could acquire a pool of mortgages and be exempt from corporate tax (as is the case with fixed investment trust mortgage pools) on the earnings of

the pool. The tax incidents of owning mortgages generally would be unchanged from present law, and all tax liabilities associated with direct ownership of mortgages would be borne by the investors. Unlike a fixed investment trust, however, a TIM could actively manage its portfolio of assets so as to provide for call protection against unexpected prepayments. In addition, fast-pay, slow-pay interests in the mortgages would be permitted. Because of these features, a TIM security could be superior to traditional fixed investment trust mortgage-backed securities using equivalent mortgages. The Administration supports these general aspects of S. 1822, which are consistent with the TIMs concept as originally developed by the President's Commission on Housing.

Under S. 1822, FNMA and FHLMC would be prohibited from being trustees, directors or shareholders of TIMs. This prohibition reflects the view by the sponsors of S. 1822 that TIMs should be used to promote activity in the secondary mortgage market by private sector entities, not by the Government-related agencies. If the Government-related agencies were allowed to issue TIMs, they could further entrench themselves in the secondary mortgage market and forestall the development of viable private sector issuers of mortgage-backed securities.

The Administration agrees that TIMs should be limited to private sector issuers. Nevertheless, we believe that the prohibition in S. 1822 may be too restricted. S. 1822 does not affect or limit the involvement of GNMA in any aspect of TIMs, nor does it prohibit the Government-related agencies from being issuers of TIMs or from having agency securities used as assets of TIMs established by private persons (such as investment bankers). TIMs funded by agency securities would have a distinct competitive advantage over TIMs established without the benefit of Federal agency backing, and might even be viewed as superior to corporate debt obligations.

S. 1822 also does not preclude the Government-related agencies or others from using any of the alternative types of mortgage-backed securities that may have some or all of the advantages of TIMs. These include multiple class mortgage REITs, partnerships substantially all of whose assets consist of mortgages or mortgage-backed securities, or mortgage-backed bonds. FHLMC has issued at least $1.5 billion of these mortgage-backed bonds in a fast-pay, slow-pay format (known as "Collateralized Mortgage Obligations") within the past six months. Without rules to preclude these "TIMs-like" securities, the Government-related agencies would retain much of their present advantage over potential private sector issuers of TIMs, especially if these TIMs-like securities are structured to maximize their tax avoidance potential.

To ensure the maximum amount of competition between the private sector and GNMA, FNMA, and FHLMC, the Administration would support TIMs legislation only if it prohibits the agencies from issuing TIMs and TIMs-like securities, and prohibits securities of the agencies from being used as collateral for privately issued TIMs-like securities. In our view, the Government-related agencies should retain their ability to operate in the portion of the secondary market that they now dominate -- the market for single-class fixed investment trust securities. New types of mortgage-backed securities should be reserved for the private sector.

At a technical level, S. 1822 has several defects. The bill would treat TIMs shareholders as if they were partners in a partnership. The Administration objects to this treatment for the reasons previously discussed regarding the problems with mortgage-backed securities issued in partnership form, namely, excessive complexity, and the possibility of creating tax shelters or tax deferred interests. We believe that paper tax losses of a TIM should not be allowed to TIM investors, and that there should be a single set of statutory rules for allocating the income of the TIM. Furthermore, S. 1822 has no effective mechanism to adjust the tax liability of TIMs investors who purchase their interests from prior owners at a premium or discount. This may make TIMs investments relatively less desirable than direct investments in mortgages.

Another significant problem in S. 1822 is that the bill would allow a person (such as a thrift institution) who contributes depreciated mortgages in exchange for an interest in the TIM to recognize losses that would not have been recognized if the mortgages were not contributed to the TIM (in which case the losses would not be recognized until the mortgages were sold). Since ownership of a TIM represents an ownership interest in the TIM's mortgage assets, it is inappropriate to allow or require a taxpayer to recognize losses on a contribution of the mortgages unless and until he sells his TIM shares. There are a number of other technical problems in S. 1822 that must be resolved in order to create a properly functioning pass-through vehicle that does not lend itself to abuse.

In the near future the Administration will propose an alternative TIMs statute that is responsive to the concerns outlined here. The Administration's TIMs proposal will authorize a mortgage investment vehicle that combines the characteristics of a Subchapter S corporation, a partnership, and a REIT. In general, a TIM will not be subject to tax. Any current interest or discount income generated on mortgages held by the TIM will be allocated to the TIM stockholders on a current basis, regardless of whether the income is distributed. There will be no dividends paid deduction, no mandatory distribution requirements, and no

earnings and profits accounts. The Administration proposal will limit TIMs to mortgage-related and cash equivalent investments of a specified class. TIMs will not be allowed to have any active business income (such as fees for mortgage origination or servicing).

Under the Administration proposal, a TIM would be required to meet definitional tests similar to those applicable to a REIT. However, the 100 shareholder requirement and personal holding company restrictions applicable to REITs will be waived. FNMA, FHLMC, and GNMA would be prohibited from being issuers, managers or shareholders of a TIM, and would not be permitted to guarantee TIM assets or TIM shares.

The goal of the rules for TIMs under the Administration's proposal will be to allocate to the TIM stockholders the same amount and character of taxable income, in the aggregate, as would have arisen had the mortgages been held outside of the entity. When all TIM shares are not identical, the Administration proposal will allocate the TIM's income by looking first to the investors who are receiving priority cash distributions from the TIM. Since the goal is to allocate the tax liability associated with mortgages in the pool without altering the basic rules governing taxation of mortgages, retirements or dispositions of mortgages held by the TIM will be treated as if the TIM shareholders retired or disposed of the mortgages held by the TIM. A concept of "par value" of TIM stock will be used to correlate transactions in mortgages by the TIM with the tax treatment of TIM shareholders. Thus, "fast-pay, slow-pay" classes of stock will be facilitated.

To the greatest extent possible, the TIM will be required to provide investors with information setting forth the amount of each investor's taxable income, capital gain, and adjusted basis for tax purposes. If an investor purchases his interest from another investor at a premium or discount compared to the former investor's basis, the premium or discount will be separately amortized by the new investor in a manner similar to the treatment of discounts and premiums on direct mortgage investments. However, if the new investor informs the TIM of his purchase price, the TIM will be able to provide him with the appropriate amortization calculation.

A TIM will be disqualified from flow-through treatment (and will become taxable as a regular corporation) only in rare circumstances. Penalty taxes will be used in lieu of disqualifying the TIM as a means of enforcing the qualification requirements in most instances.

A thrift institution or other taxpayer who contributes mortgages to a TIM in exchange for TIM shares generally will

recognize no gain or loss until the TIM shares are sold. The TIM will account for a contribution of property on a "mark to market" system; the TIM's cost basis in the mortgages will be considered to be equal to their fair market value when contributed. A contributing shareholder will be entitled to certain adjustments to compensate for the difference in the fair market value of the assets and their adjusted basis to the contributing shareholder so as to approximate the tax results that would have obtained if the mortgages had not been contributed to the TIM.

The Administration proposal will contain other provisions designed to prohibit TIMS-like transactions using Government-related agency securities, including multiple class partnerships, REITs, or mortgage-backed bonds. In addition, our proposal will deny the installment sale reporting method in connection with long-term "builders' bond" arrangements.

It is our hope that the Congress will give the Administration proposal serious consideration so that we may accomplish our objective of strengthening the private secondary mortgage market. We believe that our proposal will provide significant benefits to homebuyers, home builders, financial institutions and other investors, while prohibiting abusive transactions and reducing the Federal Government's direct and indirect involvement in the secondary mortgage market.

Taxation of FHLMC

Consistent with the Administration's objective of fostering privatization of the secondary mortgage market, the Administration also proposes that FHLMC be made subject to Federal income taxes.

Freddie Mac is owned by the Federal Home Loan Banks, which in turn are owed by private savings and loan institutions. Freddie Mac also has authority to sell preferred stock to private shareholders. Moreover, Freddie Mac is a direct competitor of Fannie Mae in that they both purchase the same classes of mortgages for use as mortgage-backed securities. However, Fannie Mae (as well as the new wholly private issuers of mortgage-backed securities) are fully subject to Federal income tax.

The stated purpose of the Freddie Mac tax exemption, which was provided by a Senate floor amendment to the Emergency Home Finance Act of 1970, was to enable it to accumulate capital and to compete with Fannie Mae, an established entity. In addition, it was stated that Freddie Mac was not expected to make a high profit. Lastly, it was asserted that it would be unfair to tax Freddie Mac since the earnings of its stockholders, the Federal Home Loan Banks, are tax exempt.

These arguments no longer are persuasive. Freddie Mac is highly profitable and has a 14-year record of success in the secondary market. The failure to tax Freddie Mac directly benefits private thrift institutions and future preferred stockholders of Freddie Mac, who may expect to receive substantially larger dividends than if Freddie Mac were taxed. Finally, the tax exemption of Freddie Mac gives it a substantial economic advantage over its taxable competitors. When Freddie Mac was organized, the then Chairman of the Senate Banking Committee stated that the tax-exempt status of Freddie Mac should be reexamined if Freddie Mac obtained a "net advantage" over Fannie Mae. We submit that Freddie Mac now does enjoy such a net advantage.

Finally, if Freddie Mac is made taxable, appropriate provisions should be included in the legislation to insure that losses on Freddie Mac's mortgage portfolio that were accrued but not realized during its tax-exempt period will be unavailable to shelter its future income from taxation.

This concludes my prepared remarks. I would be happy to answer any questions you may have.

Senator DANFORTH. Mr. Woodward, thank you very much.

Mr. WOODWARD. Thank you.

Senator DANFORTH. I take it from your testimony that the administration is on the same wavelength as the three Senators who testified earlier?

Mr. WOODWARD. That is correct, Mr. Chairman.

Senator DANFORTH. And have you been working with Senator Tower and Senator Garn and Senator Proxmire to try to work out any differences of opinion?

Mr. WOODWARD. There have been discussions, so I think it is fair to say that we have been working with them. We have some fairly fundamental differences with their bill, and those remain to be ironed out before we are completely on the same wavelength; but we are hopeful that we will be able to come to a meeting of the minds.

Senator DANFORTH. Do you share their view on the inclusion of Fannie Mae and Freddie Mac?

Mr. WOODWARD. Absolutely. I think our difference is that we would go a little farther in insuring that those agencies don't run the private sector issuers out of this particular market.

Senator DANFORTH. Thank you very much. I am going to have to recess this hearing for about a half-hour, and we will be back at about 11.

[Whereupon, at 10:30 a.m., the hearing was recessed.]

AFTER RECESS

Senator DANFORTH. Mr. Carl, Ms. Hallbauer, Mr. Hall, and Mr. Pryde.

Let's see—there are only three people here? Who is missing? Is Mr. Carl here?

Mr. CARL. Right here.

Senator DANFORTH. All right. Please proceed.

STATEMENT OF BERNARD J. CARL, ESQ., WILLIAMS & CONNOLLY, WASHINGTON, D.C., FORMER CHAIRMAN, HOUSING COMMISSION COMMITTEE, PRESIDENT'S COMMISSION ON HOUSING, WASHINGTON, D.C.

Mr. CARL. Mr. Chairman, I served as a member of the Federal Credit Program's Committee of President Reagan's Housing Commission, which looked into the question of providing mortgage credit for American families in the coming decades.

In its deliberations, the Commission identified mortgage securities as an essential part of the future mortgage finance system of our country. In 1983, 40 percent of all home mortgages will be securitized—that's over $80 billion.

The Commission also found that the mortgage securities industry was frustrated by unintentional tax and regulatory restrictions. Despite the scope and importance of this market, there are no clear tax and regulatory mechanisms for pooling and securitizing mortgages.

The Commission identified a package of reforms to encourage the mortgage securities industry, particularly private sector entities, to participate in this market. These reforms have found expression in

S. 1821 and S. 1822. I believe Senators Garn and Tower deserve great credit for their foresight in introducing this package of reforms which should be considered as a package.

Taken together, S. 1821 and S. 1822 represent a potential charter for the future of the housing finance industry in this country. Together, they have the capacity to decrease homeownership costs and make homeownership available to more families, to broaden the sources of mortgage credit, to foster the growth of a truly private secondary mortgage market, and to provide clear rules for the rapidly growing and substantial secondary market industry.

The tax legislation before you today is a crucial portion of that package.

Senator DANFORTH. Thank you very much.

[Mr. Carl's prepared statement follows:]

STATEMENT OF BERNARD J. CARL

Mr. Chairman:

My name is Bernard Carl. I am a partner at the Washington Law Firm of Williams & Connolly and I am appearing today in my capacity as a former member of the President's Commission on Housing. While serving on that Commission, I chaired the Committee on Credit Programs which recommended the package of regulatory and tax reforms which ultimately led to the introduction of the TIM's legislation before you today. I thought it would be useful to explain to this Committee the historical context and policy reasons which led to the Housing Commission's recommendations.

I. DEVELOPMENT OF THE SECONDARY MORTGAGE MARKET

The mortgage delivery system is in a period of transition. For most of the past half-century, housing funds have been provided primarily by depository institutions whose cost-of-funds were protected by regulatory interest rate ceilings. A pattern of increasing volatility of interest rates led to periods of disintermediation and resulting mortgage-credit shortages. These cyclical credit shortfalls brought with them the need for housing to tap the broader capital markets for funds.

31-489 O—84——5

The initial vehicles for access to the broader capital markets were the government-sponsored secondary mortgage market agencies. The first such agency was the Federal National Mortgage Association (FNMA) which financed its portfolio purchases of mortgages with corporate debt securities.

In the late-1960s, attention began to focus on the potential market for securities representing interests in identifiable pools of mortgage loans. This led to the development of HUD's Government National Mortgage Association (GNMA) mortgage-backed securities program. The GNMA program is limited to pools of homogenous FHA-insured and VA-guaranteed loans. The Federal Home Loan Mortgage Corporation (FHLMC) and later FNMA have provided a similar pooling and securitization vehicle for conventional mortgage loans.

The securitization of mortgage pools has also been aided by the revolution in financial management technology. The same computer technology that has fostered money market funds has made possible the nation-wide marketing of securities collaterized by large mortgage pools. The proportion of residential mortgage loans being securitized increased from roughly 5% in 1970 to well over 20% in 1982. Approximately 40% of mortgage originations are expected to be sold in the form of mortgage securities this year.

The rapid growth in the mortgage securities market has not gone unnoticed by the private sector. Recent regulatory reforms have brought into this market several well-capitalized participants. The private market is now poised to take an increasing role in the provision of mortgage credit through the capital markets.

These changes in the secondary mortgage markets have occurred against the backdrop of dramatic deregulation in the financial services sector. Depository institutions, which have been traditional sources of mortgage credit, have lost their regulatory protection against interest rate volatility. They can no longer afford to finance long-term fixed rate mortgages with short term deposits. These institutions need to be increasingly conscious of matching their assets and liabilities. Hence, they must seek ways of mitigating the risks of long-term fixed-rate mortgage lending. Consumer resistance to accepting this risk has resulted in an increasing focus on securitization as a way of diversifying this risk.

Moreover, traditional mortgage lenders continue to be haunted by the large portfolio of fixed-rate loans that are the legacy of their heavily regulated past. The potential securitization of their portfolios offers dramatic opportunities for monetizing these assets and restructuring their balance sheets.

II. GENESIS OF THE TIMs PROPOSAL

While the benefits pooling mortgages to collateralize securities have become increasingly clear, the 1981-1982 President's Commission on Housing found that the process of securitization was being frustrated by frequently unintentional regulatory and tax barriers. The Housing Commission set forth an ambitious agenda of regulatory reforms to facilitate the development of an active private mortgage securities industry. These regulatory reforms have come to be known by the acronym TIMs, or Trusts for Investments in Mortgages.

As part of the TIMs initiative several agencies have implemented administrative reforms, which have brought major financial service entities into the mortgage securities industry for the first time. The Department of Labor has issued a series of ERISA class exemptions and regulatory clarifications to facilitate pension fund investment in mortgages securities. The Federal Reserve Board has made mortgage securities marginable. The Securities and Exchange Commission has adopted new procedures for the registration of "blind pool" mortgage securities, provided for the shelf registration of mortgage securities and reclassified mortgage securities for net capital rule purposes.

The Secondary Mortgage Market Enhancement Act of 1983, S. 1821, recently reported to the floor of the Senate by the Banking, Housing, and Urban Affairs Committee, makes additional important changes to securities and banking laws and clears away the underbrush of state legal investment restrictions to further facilitate the development of the mortgage securities market. The legislation is intended to remove the legal impediments that prevent mortgage-related securities from trading on par with corporate and other pooled asset securities.

Additional regulatory reforms are needed in securities and banking laws. Particularly important are changes to facilitate dealer markets in private mortgage securities and to build upon the existing delivery system for mortgage credit. For example, the thrift industry, which has been the mainstay of that delivery system, should be permitted to have mortgage financing subsidiaries subject to the bad-debt deduction provisions of Section 593 of the Internal Revenue Code. Thrifts should also be permitted to sell mortgage-related securities to their depositors, who historically have provided the largest source of funds for housing credit.

III. THE TAX CODE IMPEDIMENTS TO MORTGAGE SECURITIES

The Housing Commission found that one of the most intractable barriers to the development of a private mortgage securities industry was the internal revenue code. Crucial to the securitization of mortgages is the availability of a conduit-entity which can pass income through to investors without taxation at the mortgage pool level. We discovered that none of the existing flow-through entities fit the characteristics of mortgage pool securities.

Features such as the uncertainty of prepayments, foreclosure, and delinquency as well as monthly rather than semi-annually or annual payments make mortgage assets more difficult to pool than corporate securities. Until the spring of 1983, virtually all mortgage-backed securities were issued in "grantor trust" form. But, the "grantor trust" is inflexible and limited, severely constricting the ability of mortgage securities to compete in the capital markets.

The "grantor trust" is, by definition, a passive vehicle. The trustee has no investment discretion and little ability to manage cash flows. Each grantor trust certificate holder has an undivided proportionate interest in the mortgage pool. Hence, each certificate has the same maturity and cash-flow characteristics as the mortgage pool itself. This inflexibility is ill-suited to mortgages for several reasons:

o Call Protection. As market rates decrease, some homeowners will prepay their mortgages by refinancing. The inability to reinvest or manage cash flows makes it impossible for the mortgage security issuer to provide investors with any protection against this prepayment or call. Since investors cannot know the duration of their investment, they have no certainty as to maturity or yield. For most investors, this yield uncertainty and reinvestment risk are unacceptable, at least without substantial price concessions.

o Maturity. Since each grantor trust certificate represents an undivided interest in all mortgages in the pool, each security must have a nominal maturity coincident with the pay-off of the last mortgage in a pool. This effectively limits mortgage securities to the long-term debt market.

o Other. There are severe limitations on the interim investment of funds pending the delivery of mortgages or between periodic disbursements of income to investors. Thus, "blind pool" securities and other than monthly payment dates are generally impractical.

The Housing Commission's identification of the problems inherent in the "grantor trust" device has led to a search for alternatives. In June 1983, FHLMC issued a collateralized mortgage obligation (CMO), heralded as the beginning of the "TIMs Era".

The June CMO offering was a corporate debt obligation of FHLMC, collaterized by a $1 billion mortgage pool. FHLMC has limited reinvestment authority and the CMO offering was segmented into bonds with three different maturities. The "short-term" class will receive all the principal payments and prepayments as well as semiannual interest payments from the mortgage pool until its certificates have been retired. Then, these payments will be made to the next class of investors, and so forth, until all principal is exhausted. The success of FHLMC's CMO proved the need for a more flexible device than the "grantor trust" to finance mortgage pools.

The CMO resulted in a reduction in the cost of funds over "grantor trust" certificates representing similar mortgages of almost 90 basis points. Of course, as the multiple class mortgage securities become more generally available, this differential is likely to decrease significantly. While it is too early to predict with any certainty, there is evidence indicating that the efficiency of this structure should ulitmately provide a savings of 30-50 basis points.

Even more important, the CMO allowed a single pool of mortgages to meet the disparate investment preferences of a variety of investors. Seventy five percent of the short term CMO securities were purchased by depository institutions, which needed short-term assets to balance their deposit liabilities. Pension

funds and insurance companies purchased 95% of the intermediate-term class; and 87% of the longest-term class were purchased by pension funds, which found the implicit call protection of these securities particularly attractive in view of the long-term liability structure of a pension fund.

The CMO model is, however, of limited utility. First, FHLMC's unique tax exempt status massively simplifies the issuance of such multiple-class mortgage securities. Second, the CMO corporate debt device has balance sheet implications which most potential issuers cannot sustain. Third, the CMO corporate debt model also raises difficult issues for investors as to the sanctity of collateral in that the investor, as a mere secured creditor of the issuer rather than a proportional owner of the mortgage pool, bears the risk of the issuer's insolvency. Even if the investor's right to the collateral is protected, the issuer's insolvency could accelerate the mortgage bond, creating uncertainty as to ultimate yield. Fourth, some categories of potential mortgage securities issuers are regulatorily prohibited from issuing collaterized debt. Finally, a CMO-type bond is not an interest in real property loans for tax and regulatory definitions crucial to thrift institutions.

Other issuers have experimented with alternative flow-through entities. The result has been a series of contrivances such as a corporation with a 1,000 to 1 debt-to-equity ratio. Considerable analysis has been given to the use of real

estate investment trusts (REITs), regulated investment companies, and partnerships as potential mortgage security vehicles. The lesson of this analysis is that none of these existing flow-through entities fit the peculiar characteristics of a mortgage pool. The REIT requirements concerning minimum number of shareholders and minimum dividend distributions as well as the tax treatment of disproportionate corporate dividend payments make the REIT "dividends paid deduction" model cumbersome and impractical for mortgage securities. The complex securities law requirements for regulated investment companies, particularly those concerning investors' redemption rights, make this corporate analogue even less appealing. The accounting requirements applicable to partnerships make the partnership an impractical vehicle for highly liquid securities, and a partnership opens up the possibility of abusive tax-shelters.

Discussions within the mortgage securities industry and with the Treasury Department led to the inescapable conclusion that it was better to start with a clean slate and to create a new flow-through entity which fits a mortgage pool's characteristics. The new entity should provide needed flexibility but avoid the potential abuses in other instruments. TIMs is the result of that effort.

IV. THE TIMs TAX PROPOSAL

Senators Garn and Tower have exhibited great leadership and understanding of the regulatory and tax problems faced by the developing mortgage securities market. In August 1983, they introduced S. 1821 and S. 1822 as a private mortgage securities deregulatory initiative. The Treasury Department efforts over the last year have also produced a well balanced and complete TIMs tax proposal.

My understanding of the Treasury proposal is that it contains the following important features:

- All income is taxed currently to investors as if they owned the underlying pooled mortgages.
- Multiple classes (hence serial maturities) of TIM securities are possible, with clear and fair rules as to the allocation of income among these classes.
- Reinvestment of mortgage pool cash-flows is possible.
- TIMs mortgage security is a housing-related asset for purposes of the regulatory and tax treatment of thrifts.
- The TIMs would not be subject to manipulation as a vehicle for creating potential abusive tax shelters.
- Simple reporting and compliance procedures are provided.

Nonetheless, I have two serious concerns with S. 1822 as currently drafted.

- The period permitted to accumulate the mortgage pool should be reduced from 18 months to 120 - 180 days to avoid a potential misuse of this provision to provide construction loans or hold non-mortgage assets for up to 18 months.

- Minimum qualification standards should be imposed on participants in this nascent industry. Only mortgages originated and serviced by regulated depository institutions and HUD-approved mortgagees should be included in TIMs pools. Moreover, only regulated depository institutions or entities with an adequate financial capacity (as demonstrated by meeting minimum requirements for net worth, pledged assets, or guarantees) should be permitted to issue TIM securities.

V. THE FEDERALLY SPONSORED AGENCIES

Finally, a careful balance must be struck between the important and legitimate role played by the government secondary mortgage market agencies and the significant danger that these agencies could overwhelm private conduits while the private mortgage securities industry was still is in a vulnerable developmental stage.

The federally sponsored agencies have and will continue to play a major role in providing mortgage credit. These agencies, with their implicit federal guarantees, agency status, proven expertise and capacity, and high level of liquidity and market visibility, could well make a major contribution towards establishing the marketability of TIMs securities. However, the very same advantages give these federally sponsored agencies, if unconstrained, the ability to overwhelm their new private competitors.

A balance must be struck between the public and private sectors of the secondary mortgage market. More competitiion in that sector can only benefit the homebuilding industry and the homebuyer, by providing a broader array of services at the best prices. Such a balanced approach can take any number of forms. For example, TIMs could be just as valuable a tool for restructuring FNMA's badly mismatched portfolio as it would be for restructuring a thrift's assets. FNMA's successful portfolio restructuring would benefit FNMA, its customers and, indirectly, its implicit government guarantor. Moreover, a limited use of TIMs for loans already in FNMA's portfolio and other carefully targetted agency TIMs programs could provide additional uniformity and liquidity to the mortgage securities market, without discouraging private competition.

VI. SUMMARY

Taken together, the administrative reforms already accomplished, the securities and banking law revisions embodied in S. 1821, and the proposed TIMs tax legislation reprsent a new charter for the future of the mortgage finance industry. These proposals have the potential to decrease the cost of home ownership, open up broad new sources of capital for housing, foster the growth of a private mortgage securities industry, and provide a clear and rational set of guidelines for the rapidly growing secondary mortgage market. With the help of this TIMs package, the private mortgage securities industry will be capable of meeting an increasing proportion of mortgage credit demand. The tax proposal before this Committee is a critical element of this package.

Senator DANFORTH. Ms. Hallbauer.

STATEMENT OF BARBARA A. HALLBAUER, EXECUTIVE VICE PRESIDENT, NORWEST MORTGAGE, INC., AND RESIDENTIAL FUNDING CORP., MINNEAPOLIS, MINN.

Ms. HALLBAUER. Thank you for this opportunity to express our support for the TIM's concept. The goal of that concept is to increase the flow of capital to the housing market by eliminating the barriers that currently exist surrounding the issuance and sale of mortgage-backed securities.

Norwest supports the TIM's concept because it would permit mortgage-related securities issued by the private sector to compete more favorably with other investment vehicles available in the capital markets.

We strongly believe that the Government-related mortgage agencies currently benefiting from a preferred status in the capital markets should not have the authority to issue TIM's or like securities.

TIM's legislation will increase the private sector's participation in housing finance and the secondary mortgage market, and at the same time not lead to the displacement of the Government-related agencies in such markets.

Finally, we believe that the TIM's concept will result in greater participation in the secondary mortgage market by a wide range of financial institutions. Private mortgage-backed securities should and will play an important role in expanding the secondary mortgage market as the result of the passage of the TIM's legislation.

I thank you and the committee for the time allotted me.

Senator DANFORTH. Thank you very much.

[Ms. Hallbauer's prepared statement follows:]

STATEMENT OF BARBARA A. HALLBAUER, EXECUTIVE VICE PRESIDENT, NORWEST MORTGAGE, INC. AND RESIDENTIAL FUNDING CORP.

Thank you, Sen. Dole for giving me this opportunity to appear on behalf of Norwest and express our support for the Trusts for Investment in Mortgages ("TIMs") concept. The goal of that concept is to increase the flow of capital to the secondary mortgage market.

Norwest supports the TIMs concept because it would permit mortgage-related securities issued by the private sector to compete more favorably with other investment vehicles available in capital markets. Presently, tax and other laws and regulations limit privately-issued mortgage securities to a structure and format which is unappealing to most investors when compared with other investment vehicles such as corporate debt, mutual funds and government-issued mortgage securities. The regulatory and tax disadvantages for privately-issued mortgage-backed securities are largely inadvertent. They arise from measures directed at other problems and enacted without considering the incidental effects on privately-issued mortgage-backed securities. The TIMs proposal represents a change in the statutory environment for private mortgage securities that would permit issuers to structure offerings in a manner attractive to a wider range of investors.

Specifically, TIMs would permit development of a privately-issued mortgage-backed security comparable in marketability to investment vehicles such as corporate debt, managed pooled investment vehicles and government mortgage-backed securities. It would become possible to develop a private mortgage security analogous to an investment company or mutual fund -- offering an actively-managed diversified pool of individual credit risks with income passed through directly to the shareholder or certificate-holder without taxation at the pool level. Investors would thus be able to accurately predict the duration of their investment and receive semi-annual cash flows. These characteristics are simply unavailable at present for private mortgage securities. The pool structure affords the flexibility -- long available for other pooled investment vehicles -- to tailor yield and maturity characteristics to particular classes of investors. By comparison, at present private mortgage securities are locked by law and regulation into the inflexible grantor-trust passive management structure and there exists little, if any, ability to tailor cash flow, yield and maturity characteristics to various groups of investors. Thus, the TIMs concept would place private mortgage securities on a competitive parity with other investment vehicles by eliminating the present structural competitive disadvantages of private mortgage securities.

31-489 O—84——6

We strongly believe that the government-related mortgage agencies should not have the authority to issue TIMs or like securities. Again, the primary benefit of the TIMs concept is the enhancement of the competitiveness of privately-issued mortgage securities with corporate debt and various pooled investment vehicles, including government-issued mortgage securities. It is the private mortgage securities which are competitively disadvantaged by the existing regulatory environment, not mortgage securities issued by government-related agencies. These agencies -- FNMA, GNMA and FHLMC -- already compete favorably with other investment vehicles, and have functioned well without TIMs. Although TIMs will increase private sector participation in housing finance and the secondary mortgage market, it will not lead to the displacement of those government-related agencies in such markets.

Finally, we believe that the TIMs concept will result in greater participation in the secondary mortgage market by a wide range of financial institutions, including insurance companies, pension funds and other institutional investors. The deregulation of the thrift industry (and other mortgage originators) will also require an expansion in the capacity of the secondary mortgage market. Private mortgage-backed securities should and will play an important role in that expanded secondary mortgage market as a result of the passage of TIMs legislation.

I thank you and the Committee for the time allotted me today.

Senator DANFORTH. Mr. Hall.

STATEMENT OF PETER HALL, PRESIDENT, P.M.I. MORTGAGE INSURANCE CO., ON BEHALF OF SEARS, ROEBUCK & CO., WASHINGTON, D.C.

Mr. HALL. Mr. Chairman, my name is Peter Hall. I am chairman of Sears Mortgage Securities Corp., an indirect subsidiary of Sears, Roebuck & Co. I appreciate this invitation to testify before your committee this morning with respect to S. 1822. I will briefly describe our position and ask that my complete remarks be made a part of the record.

The traditional system involving the conventional home mortgage that is originated and held by a savings and loan institution is being replaced by the securitization of home mortgages into investments that have wider acceptance in the financial marketplace. Sears strongly supports S. 1822 because we believe this legislation will smooth this transition for the benefit of all concerned, especially for homebuyers throughout the United States through lower mortgage interest rates.

S. 1822 is aimed at the tax problems of the transition that I have described. These tax problems are, in reality, the shortcomings of two current mortgage investment structures, the grantor trust and the collateralized mortgage obligation or CMO. Sears believes that S. 1822, with one major amendment, will correct these shortcomings.

While grantor trusts have been widely used to structure secondary market transactions, they are inflexible insofar as reinvestment and creation of multiple classes of ownership. Thus, the grantor trust cannot be adapted to a fast-pay, slow-pay format under which investors can pick the maturity of a mortgage-backed obligation needed for their particular investment objectives.

Since last spring the fast-pay, slow-pay problem has been approached through offerings of CMO's. They have been enormously popular, and we think their popularity is proof of the economic viability of TIM's type investments. Despite the advent of CMO's, TIM's legislation is still sorely needed. Uncertainty with respect to both tax and accounting treatment of CMO's may limit their ultimate viability, because CMO's are not qualified investments for thrift institutions.

We think S. 1822, with one significant change, will adequately meet the tax shortcomings of the current mortgage investment structures. The change we suggest would be to permit TIM's to be classified as a qualifying real property loan for savings and loan investment purposes under the IRS Code. This would encourage savings and loans to commit additional funds to the residential housing market.

Sears believes that passage of S. 1822 and S. 1821 will be a significant step toward increasing investment opportunities in the secondary mortgage market. This ultimately will result in a broader secondary market for mortgages and lower mortgage interest rates for homebuyers.

Thank you, sir.

Senator DANFORTH. Thank you, sir.

[Mr. Hall's prepared statement follows:]

STATEMENT OF PETER HALL, ON BEHALF OF SEARS MORTGAGE SECURITIES CORP., A SUBSIDIARY OF SEARS, ROEBUCK & CO.

Mr. Chairman, members of the Senate Finance Committee. My name is Peter Hall. I am Chairman of Sears Mortgage Securities Corporation, and President of PMI Mortgage Insurance Company, indirect subsidiaries of Sears, Roebuck and Co. ("Sears"). I appreciate this invitation to submit the views of Sears to this distinguished Committee this morning with respect to S. 1822 - Trusts for Investments in Mortgages.

Sears, through Allstate Savings and Loan Association, plays an active role in originating and investing in residential mortgages. In addition, Sears will also participate in the origination and sale of residential mortgages through Coldwell Banker Residential Mortgage Corporation and Allstate Enterprises Mortgage Corporation. Sears is also committed to the development of the private secondary mortgage market sector.

Sears is a participant in the secondary mortgage pass-through market through Sears Mortgage Securities Corporation ("Sears Mortgage"). Sears Mortgage was formerly known as PMI Mortgage Corp. and will function as a buyer of residential mortgage loans and as an issuer of mortgage-backed securities. Sears Mortgage will function in much the same fashion as entities which are currently serving the market - such as Norwest Mortgage and General Electric Mortgage Securities Corporation.

Sears is currently committing substantial resources to Sears Mortgage and much of the success of this new program

will be dependent on the passage of S. 1822, as well as S. 1821, which is presently pending before the Senate Banking Committee.

Sears strongly supports legislation to remove administrative and tax impediments which have prevented privately issued conventional mortgage-backed securities from becoming a truly efficient and competitive means of financing residential housing. If enacted, we believe S. 1822, along with S. 1821, will provide an environment conducive to the expansion of the issuance of mortgage-backed securities by the private sector and will enable entities with liquid funds to provide the necessary funds to finance homes for this and future generations. We are particularly concerned with the effect of inflation on the ability of individuals to purchase homes. Any effort which will lead to a reduction in the cost of owning a home, such as lower interest rates, at no cost to the taxpayer, surely deserves to be adopted.

We believe that this bill will accomplish three changes. First, it will increase significantly the number and types of institutions which may invest in privately issued mortgage-backed securities. Second, it will also greatly enhance the liquidity of savings and loan associations, the traditional investors in mortgage loans. The savings and loan industry, we believe, desperately needs the option of investing in the "fast pay" portion of these securities to match their short term liabilities. Third, it more efficiently distributes available residential mortgage credit. It is for these

reasons and with this goal in mind, that we both support this legislation as well as make suggestions with regard to improving it.

Background:

Conventional mortgages have always been the predominant means of mortgage financing for one to four family housing. Savings and loan associations (S&Ls or thrifts) have traditionally provided the needed mortgage funds. For example, in the past 13 years S&Ls originated approximately 80 percent of the new conventional mortgages. Until recently, S&Ls have generally been originating these loans to hold as permanent portfolio investments.

The expanding home mortgage market, however, has outstripped the ability of S&Ls to originate and hold home mortgages. During the first six months of 1983, originations of one to four family mortgages soared to an estimated $84 billion, more than double the amount for the same period of 1982. It is estimated that the total mortgage need for 1983 could exceed $170 billion.

To efficiently provide this volume of mortgage credit, an effective means of securitization and sale of mortgage-backed securities is absolutely vital. Over the next ten years, when it is estimated that up to $4 trillion will be needed to finance housing, sufficient funds will be available only by tapping new capital markets with new mechanisms.

More so than in the past, savings and loans, the traditional mortgage lenders, will not be able to meet this

need. Direct participation in mortgages can only cause savings and loans more trouble because of two factors: first, their short-term liability structure, and second, their inherent mismatch against the fixed rate thirty year mortgage still lauded by consumers. During the 1980-82 period, the borrow short and lend long policy produced heavy losses for the thrift institutions. Although their financial situation has improved, the fundamental problem of the maturity mismatch between their assets and liabilities has not changed. Worse yet, the average maturity of their deposits has shortened further, as a result of deregulation which created new short term deposits such as NOW, Super NOW, and money market deposit accounts.

The need to reduce interest rate risk has caused thrifts to adopt mortgage banking attitudes of "originate and sell" instead of "originate and hold." As long as consumers continue to demand long term fixed rate mortgages, the thrifts will be under pressure to continue originating long term loans. It is necessary that an effective escape valve be available to thrifts so that they can not only originate and sell loans but also can match investments in mortgages to their liability positions.

S. 1822, if amended as we propose, will achieve both purposes of originate and sell, and originate and hold. If not amended, only the first purpose of originate and sell will be aided and, even in that case, perhaps not aided sufficiently because of our concern that savings and loans

will not be able to make sufficient investments in TIMs to make the TIMs legislation as effective as it could otherwise be.

As the thrifts are no longer in a position to self-fund housing, there is an urgent need for legislation which will further enhance the role of the private sector and the capital markets in providing housing finance. Attempts have been made in this direction over the last 15 years, and particularly since 1976. Pooling mortgages and issuing securities backed by these mortgages - mortgage securitizing - has been practiced since 1970 when GNMA made its debut in the capital markets. FHLMC's ("Freddie Mac") participation certificate program has been in existence since 1971 to securitize conventional mortgage loans but it was not until 1976 that the Wall Street dealer community was engaged to help distribute these participation interests.

These financings are usually structured as "grantor trusts" or conduits for federal income tax purposes. However, because of rulings by the Internal Revenue Service with regard to grantor trust status, and the limitations on reinvestment and non-prorata distribution imposed by the Internal Revenue Service with respect thereto, grantor trust utilization has satisfied the needs of only a limited number of investors.

A second type of mortgage investment is the mortgage-backed bond. Such bonds have been present for years in a conventional format of being collateralized by mortgages on

the basis of market value. More recently, cash flow or pay-through bonds have been created in which the bonds are collateralized by mortgages on the basis of cash flow rather than market value.

During the last several months a new twist on cash flow bonds has become a Wall Street phenomenon with a substantial volume of issues registered and offered for sale to the general public. This newest vehicle is known as collateralized mortgage obligation, or CMO. The first such offering occurred this spring and was followed this summer in a large public offering by Freddie Mac of "fast pay-slow pay" securities. Since then an increasing number of offerings and shelf filings have been registered for sale. The CMO will be compared with TIMs later in this statement.

With the increasing need for mortgage financing and the decreasing availability of savings and loans to invest for the long term, mortgaged-backed securities will provide a liquidity necessary for healthy mortgage asset management and will enable the market risk or long term fixed rate mortgage loans to be shared by a broader investor base. We believe this new era of mortgage-backed securities has already been introduced by the targeting of specific investors with specific portions of issues of mortgaged-backed securities through the CMO process utilizing the fast pay-slow pay technique. The CMO process has created a short term obligation for thrifts to match their short term liabilities; medium-term maturities for life insurance

companies, and long and stable maturities for pension funds. S. 1822 will address these investor categories and will open up important new sources of mortgage credit. For that reason, we encourage your Committee to approve this bill.

* * * * * * * * * * *

We would now like to comment upon specific provisions of S. 1822. The bill addresses several major problems involving mortgage-backed securities.

First, call protection is provided to certain investors by permitting TIMs to reinvest certain funds during a short period of time not exceeding one-third of the expected life of the TIMs assets or seven years, whichever is less.

Second, by permitting reinvestments by TIMs, available funds can be tapped rather than wait until the mortgages are available. The grantor trust format does not permit reinvestment and accordingly it is comparatively inefficient to raise funds because it must not acquire funds from the investor until the mortgages are available. Otherwise, any funds it did acquire prior to the availability of the mortgages would need to be invested to satisfy investor requirements with the consequence of disqualifying the grantor trust as a pass-through vehicle. Accordingly, the difficulty of using grantor trusts for future financings or committing in advance to future financings points out the need for S. 1822 - the TIMs legislation.

Another major problem of the mortgage industry, addressed by the TIMs legislation, is the need to create fast pay-slow pay securities. Those investors with short term needs will be able under this legislation to pick certain shorter securities and those investors with long term needs will be able to purchase longer securities, all backed by residential mortgages. Although an attempt was made to utilize a variation of the fast pay-slow pay structure, the Internal Revenue Service has now revoked the sole private letter ruling (upon which no taxpayer other than the one to whom it was issued could rely) and has indicated that it will not issue any additional rulings while the matter is under study. Accordingly, even the very modest attempt to create fast pay-slow pay security financings with a grantor trust configuration is no longer available.

In this regard we have one major suggestion, several small suggestions, and also would like to evaluate the recent flurry in the CMO market so that it is recognized that the CMO investment vehicle should not be considered a substitute vehicle for TIMs.

First, it is important that Section 7701(a)(19)(C) of the Internal Revenue Code, which defines qualified assets for savings and loan institutions, and Section 593(d), which defines qualifying real property loans for savings and loans, be amended to include the equity and debt securities of TIMs. Savings and loan institutions are a major source of investment funds and to preclude or dissuade them from

investing in TIMs would be self-defeating. Accordingly, it is essential that the securities issued by TIMs be qualifying assets for savings and loan institutions under Section 7701(a)(19)(C) and Section 593(d) of the Internal Revenue Code if they are to be at all competitive with mortgage-backed securities issued by GNMA, FNMA, and FHLMC, which under current law enjoy such status. Without qualifying asset status, TIM securities would not be able to be bought by thrifts in any significant number, thus eliminating a very significant potential market for this type of security and source of funding for the mortgage market. We believe that without access to the thrift market, issuers of mortgage-backed securities might not avail themselves, in any significant degree, of the opportunities contained in the TIMs legislation, and might continue to use the current inefficient "grantor trust" structure and the troublesome CMO structure.

Technical Comments.

With regard to Section 860 D(b)(2), we believe it would be important that the time of recognition which currently reads "any gain or loss described in Paragraph (1) shall be recognized ratably over the remaining term of the qualifying first or second mortgage" be expanded to describe the consequence of mortgage prepayment or default. Moreover, the word "ratably" is ambiguous when applied to monthly amortizing debt.

In Section 860 E(e) the term "qualified income investments" is defined. We are concerned that the requirement in Subsection 1(b)(B)(1) that a qualified income investment is a device which is acquired to provide cash to meet fixed obligations of the TIM which cannot be met from investments in other qualified obligations is too subjective and one which will be difficult to administer and difficult to comply with. We suggest this underscored clause be eliminated as its inclusion can only lead to administrative difficulties and confusion without accomplishing a significant purpose.

* * * * * * * * * * *

The collateralized mortgage obligation issues which have come to the market recently have truly opened up the marketplace to securitizing mortgages and targeting such securities to investors otherwise reluctant to commit as many funds to investments in the residential mortgage market. The success of CMOs in the marketplace is proof positive of the economic viability of the investment instruments supported by the TIMs legislation. However, it is clear that the CMO is not an ultimate answer to the problem of meeting the $4 trillion need of the housing industry.

First, CMOs are not qualified investments for thrift institutions and this alone creates an inefficient market. Second, tax problems of thin capitalization must be addressed in creating a vehicle for the issuance of CMOs. The "off-balance sheet reporting" problems that must be resolved

by certified public accountants in connection with the financial reporting of parent organizations continue to inhibit the use of CMOs. Both the tax problems and the accounting problems can be resolved - but the resolution of one causes even more difficulty in resolving the other. The legal profession and the accounting profession do not have fixed rules to resolve these issues and conflicting advice within each profession has limited the ability and willingness of companies to expand CMO offerings. We believe the uncertainty with respect to both thin capitalization questions and off-balance sheet reporting will prevent CMOs from producing a permanent solution as the market becomes more sizeable and the need for CMOs becomes greater.

In addition, investors must be assured that their investments are debt offerings and not equity offerings of the issuer. Although at least one offering utilized a real investment trust technique, the computer and computation problems as well as the application of provisions of the Internal Revenue Code were tremendous. It is unlikely that many institutions will attempt to utilize this vehicle on a frequent basis. It should also be stated that utilization of a real estate investment trust requires complex calculations as well as difficult applications of provisions of the Internal Revenue Code for which regulations have not been issued.

Accordingly, it is our belief that CMOs are positive proof of the need for TIM legislation rather than a substitute for TIMs.

In conclusion, we believe the ability of TIMs to match the needs of investors with mortgage backed security investments should produce a lower cost of funds to the TIM with the consequence of lower mortgage rates for owners of residential housing.

We appreciate this opportunity to make our views known on the issue of TIMs. We would be pleased to respond to any questions the Committee might have.

Senator DANFORTH. Mr. Pryde.

STATEMENT OF HARRY PRYDE, PRESIDENT, NATIONAL ASSOCIATION OF HOMEBUILDERS, WASHINGTON, D.C.

Mr. PRYDE. My name is Harry Pryde. I am testifying on behalf of the more than 115,000 members of NAHB, of which I am president.

NAHB endorses the concept of TIM's as introduced in Senate bill 1822. NAHB would strongly urge that the broadscale revision of the tax rules currently applicable to the secondary mortgage market not be attempted as part of the TIM's initiative.

TIM's should not be viewed as a trade-off for Treasury proposals which would have the effect of inhibiting the development of new sources of mortgages, and we would oppose any such initiatives as indicated in Mr. Woodward's testimony this morning.

Instead, TIM's as set forth in Senate bill 1822 should be viewed as a revenue-neutral means of providing for the more efficient operation of the secondary mortgage market. In addition, the scope of Senate bill 1822 should be expanded to permit the major players in the mortgage market such as Fannie Mae and Freddie Mac to participate in TIM's as trustees, directors, and shareholders, which would assist in channeling the benefits of TIM's as a homebuyer.

Mr. Chairman, we appreciate the opportunity to present our views on this most important and highly technical matter.

Thank you.

Senator DANFORTH. Thank you very much.

[Mr. Pryde's prepared statement follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

FINANCE COMMITTEE

UNITED STATES SENATE

on

TRUSTS FOR INVESTMENTS IN MORTGAGES (TIMs)

November 4, 1983

Mr. Chairman and Members of the Committee:

My name is Harry Pryde. I am a home builder from Seattle, Washington. I am testifying on behalf of the more than 115,000 members of the National Association of Home Builders (NAHB). NAHB is a trade association of the nation's homebuilding industry, of which I am President. Accompanying me today is Ed Beck, NAHB's Tax Counsel.

NAHB applauds Senators Garn and Tower for the initiative which they have taken in introducing S.1822. It helps to eliminate technical tax impediments to growth of the secondary mortgage market and is part of a series of regulatory and legislative changes that are designed to enhance the viability of the secondary mortgage market.

SECONDARY MORTGAGE MARKET

The secondary mortgage market has become the cornerstone of the entire residential mortgage finance system in America. Currently, one-half of the mortgages originated are sold on the secondary mortgage market. By 1990, the share of mortgages sold on the secondary market is expected to increase to between two-thirds and three-fourths of the total. The demand for mortgage originations during the remainder of the decade has been estimated at approximately $1.6 trillion.

This phenomenal anticipated demand for mortgage credit coupled with the decline of thrifts as portfolio lenders is dramatically increasing the importance of the secondary mortgage market for housing finance. The players in the secondary market are government-related entities -- primarily the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Government National Mortgage Association (GNMA) -- and private entities. Government entities comprise 60% of the market with private entities making up the remaining 40%.

Secondary mortgage market entities are in turn relying heavily on mortgage-backed securities to attract a variety of investors. Mortgage-backed securities represent an ownership interest in a pool of mortgages. They are uniform investment vehicles that capital market investors can evaluate and compare to other investments. Their terms can be tailored to meet different investment needs.

The investment potential of mortgage-backed securities is attracting private entities into the secondary market. NAHB welcomes their presence in the market and expects them to become major issuers in the future.

The President's Commission on Housing recognized the importance of mortgage-backed securities and pointed out that conventional mortgage-backed securities are subject to legal, regulatory and tax disadvantages vis a vis corporate debt obligations. Some of the regulatory obstacles have been removed, but others remain. In particular, it is crucial to find a means of protecting investors against prepayments and to allow active management of mortgage loan pools that back the mortgage-backed securities.

31-489 O—84——7

These obstacles place a market premium upon mortgage-backed securities. The interest rate for mortgage-backed securities is higher than the interest paid for alternatives, such as corporate bonds of the same rating, by at least 100 basis points. This translates into higher mortgage interest rates for millions of American homebuyers.

Trusts for Investments in Mortgages (TIMs) hold out the prospect of solving the tax law obstacles to the widespread use of mortgage-backed securities. As defined in S.1822, the Trusts for Investments in Mortgages Act, TIMs, would be an entity that could issue mortgage-backed securities, actively manage the underlying portfolio, and be taxed only once upon payout to the shareholders. TIMs are specialized creatures of tax law which are similar but not totally identical to mutual funds or Real Estate Investment Trusts (REIT). The tax law changes would help to eliminate the second class status of mortgage-backed securities as compared to corporate bond obligations, making mortgage credit instruments attractive to all types of investors -- pension funds, insurance companies, financial institutions and individuals.

NAHB notes that the Administration has also been developing the TIMs concept as a follow-up to the report of the President's Commission on Housing but is concerned that the Administration's approach could raise new barriers to the growth of the mortgage-backed security and the secondary market. NAHB endorses the concept of TIMs as introduced in S.1822 and urges speedy enactment of this legislation. NAHB emphasizes that participation in TIMs should be available to both the private sector and to the federally related entities -- FNMA

and FHLMC. Therefore, S.1822 should be expanded to permit FNMA and FHLMC to establish TIMs as a trustee, director or shareholder. This will ensure the maximum availability of funds from the capital markets and will help address the affordability problem that homebuyers face.

The following analysis will elaborate upon the significance of the TIMS proposal as a mechanism for providing mortgage credit, and therefore homeownership, for the millions of Americans who seek affordable homes.

MORTGAGE-BACKED SECURITIES TO FINANCE HOUSING

The mortgage-backed security has developed as a means of attracting capital to housing.

The basic feature of a mortgage-backed security, from the investor viewpoint, is that principal and interest (cash flow) are passed on to the investor as the mortgage is paid by the owner. Prepayments of principal on a mortgage are passed on, pro rata, to the investors in the trust. While the term of the mortgages may be thirty years, generally, the mortgages are paid off prior to maturity and the average dollar invested is returned to the investor after approximately 12 years.

The grantor trust is the vehicle for creating a mortgage-backed security. Grantor trusts are a creation of the tax law. They were intended to be a passive holding device for the assets of incompetents, widows, orphans and others who either did not desire to or were incapable of managing their own money. The attributes of the assets (income and deductions) are passed through to the beneficiary. The significant feature of a grantor trust is that no tax is incurred at the trust level.

Although it was never intended as an entity for holding mortgage investments, the grantor trust is the only available vehicle for packaging such investments under the current law. It has serious drawbacks. IRS regulations and case law hold that an actively managed trust, in this case an actively managed mortgage pool, would be reclassified as a corporation, meaning a double tax at the corporate and individual level. Active management involves reinvestment of prepayments or other cash flow, substitution of equivalent collateral (similar mortgages), retention of payments for annual or semi-annual coupon. These activities are essential to the development of an attractive mortgage-backed security.

MORTGAGES vs. CORPORATE BONDS: INVESTMENT AND TAX CONSIDERATIONS

As compared to corporate obligations, the tax law discriminates against mortgage-backed securities, generally because of the need to use a grantor trust. The grantor trust mechanism prevents mortgage-backed securities from having "call protection" against prepayments. Corporate bonds, on the other hand, almost universally contain call protection.

Call protection, i.e., protection for the investor against the risk of prepayment, is essential in a fluctuating interest rate environment. Prepayments of mortgages accelerate in periods of falling interest rates. Investors are paid off earlier than they anticipated, and they must reinvest at lower rates than they expected when they purchased mortgage-backed securities. This risk necessitates a higher yield on mortgage-backed securities and drives up the rate on the underlying mortgages. As a result, corporate bonds,

which normally pay interest until a fixed maturity date, have a competitive advantage over mortgage securities in the minds of pension funds and other institutional investors.

Another associated problem is frequency of principal payments. Most mortgages are paid in monthly installments of principal and interest. Under the grantor trust, principal payments must be passed through to the investor. This makes mortgage-backed securities unattractive because institutional investors, pensions and insurance companies prefer quarterly or semi-annual payments, usually of interest only.

The tax treatment of gains and losses is another disadvantage of mortgage securities. The Report of the President's Commission on Housing notes:

> The IRC stipulates that investors in corporate obligations may treat the recovery of discounts (other than original-issue discounts) on sale or retirement as capital gains, rather than as ordinary income. Conventional mortgage-backed securities, however, are considered by the Internal Revenue Service to represent the obligations of individual mortgagors, and thus the securities are not entitled to the favorable treatment available to corporation obligations under the IRC; in effect, [conventional mortgage-backed security] holders are required to treat the recovery of all discounts through principal payments as ordinary income. This restriction places deeply discounted low-coupon mortgage securities at a particularly competitive disadvantage in the general capital markets, even though certain investors would otherwise seek to acquire such securities. (Report page 146)

TIMs ALTERNATIVE

The investment community and the housing community have combined to develop an alternative entity to the current grantor trust mechanism. This entity would issue an instrument which would be competitive with corporate bonds, thereby increasing the attractiveness of mortgage-backed securities.

The main purpose of TIMs would be to provide for a flexible entity to hold mortgages and issue an ownership interest to investors which would meet the needs of the investment community. It would issue a security representing an interest in a pool of mortgages (a mortgage-backed security or participation certificate).

The attributes of TIMs which the housing community has developed are:

- Active management to reinvest mortgage principal payments. This would permit the return of principal and interest on a regular, predictable schedule.
- No taxation at the entity level when the entity engages in active management of a pool of mortgages.
- Multiple classes of securities so that investors who want a regular schedule of payments will receive those in a manner similar to corporate bonds, while other investors who want earlier payments of principal or cash flow may also receive these payments (i.e. the fast pay -- slow pay distinction)
- Capital gains treatment for principal payments on discounted mortgages which can be passed through to the investor. Those in the business of mortgage lending would not be allowed this benefit.
- Treatment of regular payments to investors as interest for all tax purposes, regardless of the label attached to the payments (i.e. dividends).
- Ability of TIMs to hold initial start-up government securities, CDs, etc. during the time in which the mortgage pool is being formed.
- Broad TIMs applicability including FNMA, FHLMC, and GNMA mortgage pools.

To accomplish these objectives, the structure, for tax purposes, is basically a pass-through entity. Several such entities now exist in the tax law. They are REITs, mutual funds, partnerships, Subchapter S corporations, and some trusts. The structure would be a new entity which would be designed exclusively for the purpose of holding mortgage securities and passing out income and principal to

investors. Investors would hold an interest in the structure which would be a security, somewhat analogous to stock ownership in a corporation, but the security would have payment features and protection of principal similar to a corporate bond.

TAX POLICY CONCERNS

In developing this completely new entity, legitimate tax policy concerns must be met.

The entity must not be a mechanism for converting ordinary income into capital gains for those in the business of dealing in mortgages. Also, the entity must not be a vehicle for holding assets other than mortgages, except where necessary to pay investors under the terms of the obligation.

These and other policy concerns must be dealt with to prevent abuses and to ensure that the vehicle accomplishes its intended purposes. At the same time, overly restrictive requirements should be avoided and the requirements should be as simple as possible, if the entity is to appeal to the investment public.

DESCRIPTION OF S.1822

S.1822 creates the TIMs entity. To qualify as TIMs, the following requirements must be met:

- Investment requirements (gross income test, assets test).
- An active conduct of business test.
- An election test.
- A class of stock test.

TIMs are not taxable at the entity level, but must use the cash method of accounting on a calendar year basis.

Shareholders in TIMs are entitled to capital gains treatment from the sale of TIMs assets if they would otherwise qualify. An exception is provided for a 20% shareholder who is a dealer in mortgages, who must treat capital gains as ordinary income.

The type of obligations which TIMs may hold include a qualified first or second trust as well as short-term instruments during an 18 month start-up period. In addition, certain other types of obligations would qualify. Construction loans and original issue discounts would not qualify. Under S.1822, FHLMC and FNMA are expressly ineligible to be trustees, directors or shareholders of TIMs.

Penalties are provided for failure to meet TIMS qualifications and for TIMS engaging in prohibited transactions.

TIMs AND THE ALLOCATION OF CAPITAL TO HOUSING

S.1822 is an important policy initiative, which NAHB supports. It signals a willingness on the part of Congress to provide workable rules for housing finance to compete in the new financial environment. It provides momentum behind proposals to expand the investment attractiveness of mortgage-backed securities and to strengthen the secondary market. In so doing, it should involve no tax revenue loss and has the potential for reducing mortgage interest rates, thereby providing for a more stable and sustained economic recovery.

In the press release announcing the hearing, Chairman Dole indicated that the Committee would "also be reviewing generally the tax treatment of mortgage investments and the secondary mortgage market institutions."

There has been some indication that the Administration and the Department of Treasury view this statement and the TIMs legislation as an opportunity to undertake a wholesale revision of the role of the existing tax law governing the major entities participating in the secondary mortgage market. Particularly, there has been the suggestion that the tax-exempt status of FHLMC should be reviewed and that FHLMC's successful collateralized mortgage obligation program should be curtailed or eliminated. Also, changes in the rules governing the taxation of builder bonds may be advanced.

NAHB opposes these and other initiatives to curtail the support that FNMA and FHLMC provide to housing and the popular builder bond program. NAHB concurs with the conclusion of Senator Garn, the distinguished Chairman of the Banking Committee, expressed in a recent letter to the Secretary of Treasury, Donald T. Regan:

> "Consequently I believe it is in the best interests of the economy and the Administration's policy objectives to refrain at this time from further pursuit of schemes to remove government ties from FNMA and FHLMC."

The history of the secondary market shows how important the involvement of the agencies is to establish a market for a new security. Where the agencies lead, the conventional mortgage security issuers, such as mortgage insurers, financial insitutions and brokerage houses, follow. In the absence of agency participation, it is difficult to see how uniformly structured TIMs could be issued in sufficient volume to create a liquid secondary market.

As a result of excluding the agencies, TIMs will serve primarily to increase private sector profits and perhaps lower the interest rates on jumbo, non-conforming loans, but will do nothing to lower rates on the millions of mortgages for moderate priced homes which reach the secondary market through FNMA, FHLMC and GNMA.

Underlying this theme is a view that too much capital has been allocated to housing. NAHB hopes that the Committee will refrain from echoing this unfounded assertion which is disastrous for housing and the economy.

During the 1970's, when housing production surged to record levels, residential mortgages consumed 24.8% of the capital markets. That was the same amount as during the 1960's and well below the 30.9% share of the 1950's. Residential mortgages claimed only 17.5% of credit market funds from 1980-1982 and skidded further to a 13.3% share during the fourth quarter of 1982.

By comparison, the federal government has steadily increased its demand for loanable funds -- from a 7.7% share in the 1950's; to 10.3% in the 1960's; and 20.6% in the 1970's. The government has taken approximately one-third of available credit during the first three years of this decade and threatens to take significantly more in succeeding years.

The federal government cornered a whopping 57% share of the nation's credit during the final quarter of 1982, leaving little question of who the fat man is in the financial markets. Unless Congress and the Administration find the means to bring soaring annual deficits of $200 billion under control, the federal government threatens to crowd out both the business and consumer investment sectors -- not just housing. And NAHB recognizes the leadership of Chairman Dole in his effort to bring down the massive federal deficits.

Gross National Product statistics also prove invalid the contention that the use of capital by the residential sector has been a drag on the economy. They demonstrate that housing's share of total U.S. economic output has fallen today to the lowest levels since the 1940's.

At a time when the demographic demand for housing continues at a high level, people should be asking whether credit would be better spent for housing or for government borrowing. Because, ultimately, that is where the decision lies.

In addition, in the tax area, recent tax changes were designed to reduce the importance of investment in housing relative to other types of investment. As the Economic Report of the President for 1982 noted:

> The sizeable reductions in tax rates on capital income mean that real after tax returns on household savings will be substantially higher than they have been in the recent past. As a result, the implicit price of consumer durables has risen and a long run shift in demand away from housing, automobiles, and other consumer durables may result. (Page 126)

The movement in tax incentives away from housing is confirmed in a study dated October 25, 1982, by the Congressional Research Service. The study, Tax Subsidies to Housing, 1953-83 indicates that tax subsidies for housing, both owner-occupied and rental investment housing, have declined over time as compared to tax subsidies for other types of assets. The study notes "the spread between the return on business assets and the return on owner-occupied housing has diminished and in some cases disappeared. One can no longer argue unambiguously that owner-occupied housing receives a tax subsidy relative to business capital." (page 22)

NAHB views the direction of tax changes toward more savings and investment as a healthy and necessary move. The point is not that the changes should not have been made, but only that the changes have reduced the tax incentive associated with a home purchase compared to other types of investments.

Regarding rental housing, the history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. For example, the 15 year Accelerated Cost Recovery (ACRs) for structures are not the tax bonanza everyone seems to believe. NAHB supported the 1981 ACRS depreciation changes because of their certainty and simplicity, but it is a misconception to believe that the changes, in term of new residential construction, significantly increased depreciation write-offs. In fact, component depreciation plus the ability to use 200 percent declining balance often created a more advantageous depreciation situation for new housing than the situation after ACRS. The table in Appendix I analyzes component depreciation and ACRS. As the table demonstrates, component depreciation provided larger total write-offs over six years than are allowed under ACRS. The tax savings as well as interest on the tax savings amounted to a substantial sum.

The broad direction of policy has, therefore, been to shift capital away from housing and, in the mortgage finance area, to increase the cost of mortgage funds to the consumer.

There also exists in the mortgage finance area, particularly regarding residential mortgage investment, legal and regulatory requirements that are much stricter for pension funds to invest in residential mortgages than to invest in other areas. We support passage of legislation which would remove these additional barriers.

TIMs, therefore, should be looked upon as a mechanism for removing legal and regulatory barriers which have put mortgage investments at an competitive disadvantage vis a vis other sectors.

CONCLUSION

In conclusion, NAHB encourages Congress to move quickly on S.1822. NAHB would strongly urge that broad scale revision of the tax rules currently applicable to the secondary mortgage market not be attempted as part of the TIMS initiative. TIMs should not be viewed as a trade-off for Treasury proposals which would have the effect of inhibiting the development of new sources of mortgage finance. Instead, TIMs, as set forth in S.1822, should be viewed as a revenue neutral means of providing for the more efficient operation of the secondary mortgage market. In addition, the scope of S.1822 should be expanded to permit the major players in mortgage finance, FNMA and FHLMC, to participate in TIMs as trustees, directors and shareholders, which would assist in channeling the benefit of TIMs to homebuyers.

We appreciate the opportunity to present our views on this most important and highly technical area. I would be pleased to answer any questions you may have.

[redacted]

M A R R [redacted]
SIX YEAR COMPARISON
COMPONENT DEPRECIATION VS. A C R S

	COST	ESTIMATED LIFE	FIRST YEAR	SECOND YEAR	THIRD YEAR	FOURTH YEAR	FIFTH YEAR	SIXTH YEAR	TOTAL
COMPONENT METHOD PRIOR TO 1981 TAX LAW									
[redacted]	$672,[illegible]	40	$11,684	$11,910	$10,137	$20,811	$27,171	$26,002	$170,819
[redacted]	188,012	10	5,284	6,334	6,275	5,857	5,466	5,182	34,420
[redacted]	192,622	10	11,000	11,550	11,156	10,412	9,718	9,069	65,117
[redacted]	73,866	10	10,197	11,521	9,217	7,374	5,897	4,719	53,130
[redacted]	188,012	10	5,284	6,334	6,275	5,857	5,466	5,182	34,420
[redacted]	66,010	15	11,133	9,706	8,412	7,291	6,319	5,476	48,483
[redacted]	73,000	8	10,000	13,502	10,126	7,595	5,696	5,696	60,617
[redacted]	96,011	15	12,198	11,092	9,614	8,332	7,221	6,259	55,316
[redacted]	188,012	15	16,158	15,419	10,815	9,374	8,124	7,041	62,231
[redacted]	60,007	8	15,000	11,251	8,439	6,329	4,747	4,747	50,515
[redacted]	60,007	10	12,001	9,601	7,681	6,145	4,916	3,933	44,277
[redacted]	144,016	10	20,001	21,001	18,434	14,747	11,798	9,438	104,769
[redacted]	96,011	1	91,000	21,121	10,670				96,011
[redacted]	156,018	1	148,011	14,667	17,338				156,018
[redacted]	120,016	1	90,016	26,667	13,333				120,016
[redacted]	73,000	15	8,588	9,100	7,196	6,219	5,489	4,674	41,033
[redacted]	73,000	8	10,000	13,502	10,126	7,595	5,696	5,696	60,617
[redacted]	24,001	5	5,001	5,761	3,456	2,591	2,592		24,001
[redacted]	66,010	10	10,001	11,001	10,753	8,603	6,882	5,504	61,988
[redacted]	$3,668,273		$489,468	$381,191	$289,647	$243,154	$223,318	$188,674	$1,357,248
A C R S METHOD AFTER 1981 TAX LAW									
[redacted]			12.00%	10.00%	9.00%	8.00%	7.00%	6.00%	
[redacted]	$3,668,273	15	$288,011	$260,022	$216,025	$192,022	$168,019	$144,01681,260,202	
COMPARISON									
[redacted]			$201,457	$61,168	$-6,178	$-48,868	$44,701	$-15,568	$189,186
[redacted]			$201,457	$262,591	$210,215	$189,347	$144,646	$189,186	$189,186
[redacted]			$188,314	$21,581	$-1,189	$-26,416	$-22,151	$-17,778	$56,553
[redacted]			$70,161	$15,560	$14,291	$11,361	$8,679	$6,546	$80,598

Senator DANFORTH. Thank you very much.

I want to apologize to you and all the other panelists for two things: First, the delay, and second, that I am really a pinch-hitter today, and it is a little like casting pearls to the swine for you experts in this field to be testifying on an area where I don't pretend to have any real knowledge.

But I take it that you view this as very significant legislation and something that should be dealt with on a priority basis by the Congress. Is that a fair statement?

Mr. HALL. That is correct.

Senator DANFORTH. Are the benefits of this program for the housing sector obtained at the price of an increase in capital costs for other sectors of the economy, in your opinion?

Mr. PRYDE. Well, we don't think so; no. As a percentage of the capital market, housing has actually taken a much lesser percentage than in the 1950's, 1960's, and 1970's, when it was 25 or 30 percent. Last year it was 17 percent, and housing has been taking much less percentage of the capital markets.

Mr. CARL. Mr. Chairman, I should note that, as I believe the Treasury representative indicated, this is a revenue-neutral proposal. There is no implicit or explicit subsidy involved in this legislation, and it is purely a matter of making the existing secondary market more efficient. Thus, there is not a subsidy to draw funds away from other parts of the capital markets.

Senator DANFORTH. Do you agree with the other witnesses about the Fannie Mae/Freddie Mac inclusion?

Ms. HALLBAUER. Speaking for the private sector, I would say we definitely do not.

Senator DANFORTH. Do not agree?

Ms. HALLBAUER. Do not want Fannie Mae and Freddie Mac.

Senator DANFORTH. You do agree?

Ms. HALLBAUER. We do agree; we do not want Fannie Mae and Freddie Mac as Government-sponsored agencies to have this additional advantage to the exclusion of private sector interests.

Mr. HALL. Senator, we also agree with that statement.

Mr. PRYDE. Well, we feel it would be better if Fannie Mae and Freddie Mac were included in TIM's. We don't feel that they would monopolize the market, and it would help expansion in the private sector. So we don't necessarily agree with that.

Senator DANFORTH. All right.

Mr. CARL. Mr. Chairman, I may be taking the middle ground in this, but I think the Federal agencies have substantial advantages. They have an implicit Federal guarantee, an agency status, both expertise and market visibility. If they were allowed to participate unconstrained, it is true that they could probably overwhelm what is now a very young and vulnerable private industry. And for that reason, I don't think their agencies' participation ought to be unconstrained.

That is not to say there are not limited ways in which the agencies could participate. It seems to me that the burden is on the agencies to come forward with proposals for their participation which are limited enough in scope and in duration that the agencies' programs will not result in unfair competition with the private sector.

Mr. PRYDE. Mr. Chairman, let me just add that we are in favor of Senate bill 1822. Probably our greatest concern is with the Treasury position, which is punitive. We are very much against that position.

Senator DANFORTH. Thank you all very much.

Mr. Cumberland and Mr. Levy and Mr. Tuccillo.

STATEMENT OF WILLIAM E. CUMBERLAND, GENERAL COUNSEL, MORTGAGE BANKERS ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. CUMBERLAND. Mr. Chairman and members of the committee, my name is William Cumberland. I appear this morning on behalf of the Mortgage Bankers Association of America.

We appreciate the opportunity to discuss the recently introduced bills, S. 1822, which would amend the Internal Revenue Code to authorize trusts for investment in mortgages or TIM's.

MBA strongly supports the concepts embraced in this legislative proposal, as well as its companion piece, S. 1821 or S. 2040 as it is now numbered. Passage of these legislative proposals would provide a significant impetus to the development of the secondary mortgage market, which in turn would benefit home buyers and others who need real estate finance.

MBA is deeply concerned, however, that S. 1822 fails to include Fannie Mae and Freddie Mac in the benefits accorded by the TIM's proposal. We urge you to allow them to participate.

MBA also has some comments on the specific provisions of S. 1822, which are included in our written statement, which we would request be made part of the record.

Thank you.

Senator DANFORTH. Thank you very much, sir.

[Mr. Cumberland's prepared statement follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

WILLIAM E. CUMBERLAND
GENERAL COUNSEL AND STAFF VICE PRESIDENT

of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

Hearings on

S 1822, a bill amending the Internal Revenue Code to authorize Trusts for Investment in Mortgages

November 4, 1983

31-489 O—84——8

Mr. Chairman and Members of the Committee, my name is William E. Cumberland. I am General Counsel and Staff Vice President of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking and real estate finance industries. Accompanying me today is Burton C. Wood, MBA's Legislative Counsel.

We appreciate the opportunity to appear before you today to discuss the recently introduced bill, S 1822, which amends the Internal Revenue Code to authorize Trusts for Investment in Mortgages (TIMs). MBA strongly supports the concepts embraced in this legislative proposal, as well as its companion piece, S 1821, the "Secondary Mortgage Market Enhancement Act of 1983." Passage of these legislative proposals would provide a significant impetus to the development of conventional mortgage-backed security (CMBS) markets.

---

*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; Telephone: (202) 861-6500.

MBA is deeply concerned, however, that S 1822 fails to include the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) in the benefits accorded by the TIMs proposal.

Mortgage banking is a function that relies on the sale of newly originated mortgages to secondary mortgage market investors. The origination of mortgages, that is, making loans to homebuyers to purchase their homes in exchange for a mortgage on the home, is the primary mortgage market. This primary market serves not only homebuyers, but those seeking real estate financing for a variety of purposes, using mortgages on residential property as security for the loan. After a mortgage banker has made a number of loans and originated the mortgages securing repayment of the loans, the mortgages are most frequently "pooled" together and sold to an investor under a commitment to purchase, previously arranged between the lender and the investor. This sale of mortgages to long term investors is the secondary market for mortgages. Over the past fifteen years the secondary market has become even more sophisticated with the development of pass-through secondary market mortgage instruments, such as, the Government National Mortgage Association (GNMA) Mortgage-Backed Security (MBS), the FHLMC– Participation Certificate, and the FNMA Conventional Mortgage-Backed Security. These securitized instruments are bought and sold by investors and this trading market provides a vital source of mortgage capital today.

The secondary market is critically important to the operations of mortgage banking. Approximately 65 percent of the single family home loans originated in 1982 were sold into the secondary market by mortgage bankers and other lenders. Investors are increasingly interested in purchasing mortgage-backed securities rather than individual loans, because of the diversified risk and increased liquidity of the securitized instrument. In light of these factors, mortgage bankers are vitally interested in the evolution of the mortgage securities market and the proposals embodied in this legislation.

These two intiatives, if passed, would provide a substantial boost to the development of CMBS markets by easing Securities and Exchange Commission (SEC) requirements and state-imposed regulations and impediments that diminish or effectively preclude investor interest in CMBS-type instruments. The TIMs proposal would further broaden the base of investors interested in mortgage products by allowing active management of CMBS pools in order to permit reinvestment and by authorizing multiple classes of securities to meet varying investor needs as to yield and term. This move would assist the evolution and integration of the U.S. capital markets and provide a viable private sector instrument to augment the efforts of FNMA, GNMA, and FHLMC to provide homebuyers with access to the capital markets.

THE EVOLUTION OF THE SECONDARY MORTGAGE MARKET

The past few years have produced a revolution in the secondary mortgage market. While during the 1950s and 1960s, traditional investors, such as thrift institutions and life insurance companies, were principal holders of residential mortgages, the development of mortgage-backed security instruments during the 1970s broadened the types of investors interested in holding mortgages. During the past 15 years, the chief actors responsible for developing MBS products and establishing their success were the Federal and federally related agencies—GNMA, FNMA, and FHLMC. Their combined efforts in experimenting with various types of mortgage-backed securities established the acceptance of these instruments by Wall Street and, thus, expanded the universe of private sector investors in mortgage products.

At the same time this growing acceptance of MBS issuances was occurring, another significant phenomenon was taking place. Deregulation was forcing financial institutions

to attain a more perfect match between assets and liabilities as these institutions were permitted to pay market rates to depositors and forced to reappraise the types of assets and yields required to maintain profitability. In order to insure the viability of depository institutions in a volatile interest rate environment, institutions must now place greater emphasis on portfolio investments that adjust to changes in market rates of interest, so that asset yields can rise and fall more closely in line with the rates paid to depositors. Alternatively, these depository institutions seek assets that are more liquid or shorter term in nature and, therefore, may be bought and sold more easily.

Deregulation has dramatically accelerated the development of the secondary market. From 1970 through 1978, the percentage of funds for new mortgages raised in the secondary markets through loan sales to investors averaged 35 percent. Since then, the secondary market has become even more important. In 1982, the percentage of new mortgage money raised through loan sales reached almost 70 percent. These figures exclude the swaps of seasoned loans for mortgage-backed securities by thrift institutions, which are designed to ease their financial difiiculties. Furthermore, potential mortgage demand in the 1980s will match or exceed the strong pace of the 1970s. However, affordability remains a significant problem at present and foreseeable levels of interest rates.

These combined factors—the changing role of traditional mortgage investors with the concommitant trend of reliance on the secondary mortgage market as an increasingly dominant source of mortgage credit, as well as the strong, continuing, potential demand for mortgage credit—mandate that new sources of investment funds be developed, if mortgage credit is to become more affordable and attainable for American families seeking homeownership.

THE SECONDARY MORTGAGE MARKET INITIATIVES

S 1822 authorizes TIMs as a method of setting up actively managed CMBSs with certain tax advantages beyond those accorded grantor-trust type CMBSs, similar to the treatment of a mutual fund. The TIMs proposal removes tax liability at the pool level for CMBSs that are set up under specified guidelines. In S 1822, FNMA and FHLMC are specifically excluded from participating in TIMs. The proposal authorizes multiple classes of TIMs securities, which would allow investors to select different combinations of yield and term to maturity. This is similar to the attractive investment incentives available under the newly introduced FHLMC Collateralized Mortgage Obligation, which allows investors to stipulate varying terms for their holdings. That offering, which amounted to $1 billion, has been exceedingly successful, and indicates that investors with the need for investments with more certain terms are attracted to instruments that can provide this benefit.

The TIMs proposal also allows the pool manager to disburse proceeds from a mortgage prepayment to investors or to reinvest those proceeds in replacement mortgages without an adverse tax effect. S 1822 authorizes both first and second mortgages to be placed in TIMs eligible pools, so long as they are secured by a single-family, principal residence, including cooperatives. The mortgage can be to acquire or to improve a home. Finally, where proceeds from a prepayment, foreclosure payoff, retirement, or renegotiation of a mortgage need to be reinvested, the TIMs manager may make short-term investments for less than 180 days, so long as the proceeds from the short-term investments are reinvested in eligible qualified assets. These provisions direct the funds raised to private single family housing while allowing the TIMs manager some flexibility to cope with changing market conditions and to satisfy the range of maturity requirements of different investors.

MBA supports the thrust of S 1822 as a means of expanding the universe of investors who would want to purchase mortgage products that can be fashioned to accommodate their investment needs. Both S 1822 and its companion bill, S 1821, would address this need by easing securities, regulatory, and tax impediments to issuing mortgage securities and thus making CMBS issuances more attractive to investors.

NEED TO INCLUDE FNMA AND FHLMC

MBA has long championed the development of CMBSs and worked hard to ensure that mortgage securities could be traded on an equal basis with corporate securities. Development of private issues of CMBSs has been difficult and their strong entry into mortgage investment markets has been impeded because of securities and tax restraints—both at the state and Federal levels. These impediments have hamstrung the mortgage market and have made it difficult for mortgage products to be sold on a competitive basis with other debt instruments. Removal of these roadblocks would further expand the universe of mortgage finance participants and would satisfy the needs of many investors. This will increase the supply of mortgage credit, help to improve the adequacy of sources of affordable mortgage funds, and contribute to the efficient development of integrated capital markets.

Historically, GNMA, FNMA, and FHLMC have led the development of mortgage-backed securities. Although a few private CMBS issues were floated in the 1970s, they were issued on a one-time basis for the most part and did not make any significant inroads on the market. While it is important to encourage these private issuers, MBA thinks it is extremely unwise to exclude such experienced practitioners as FNMA and FHLMC from the TIMs initiative, as this might jeopardize its chance for success.

With potential home mortgage credit demand at historically high levels and the increased reliance on the secondary market, MBA believes that the emphasis should be on removing all artificial impediments to the free flow of mortgage credit and enlarging both general sources of mortgage credit—private and Government-related—rather than arbitrarily shrinking the role of Government and Government-related agencies on the untested assumption that private institutions could immediately pick up the slack.

Until an analysis of the level of mortgage demand and the ability of the private market to fulfill that need has been conducted, we believe that any discussion of a transfer of reliance from the Government-related mortgage institutions to purely private organizations is premature, as this Nation still faces mortgage rates that are historically high.

Any dismantling of the Government-related mortgage markets, now or in the near-term future, will only exacerbate the problems of affordability. Affordability and the role of the Government in ensuring adequate support for housing are the issues that must be thoroughly studied before rushing headlong into privatization. To date, to our knowledge no such studies have been undertaken.

Furthermore, it is clear that private and Government-backed markets can coexist and compete with one another, as evidenced by the strength of the conventional mortgage insurance industry and its phenomenal growth during the 1970s, despite the presence of Federal Housing Administraton (FHA) home mortgage insurance programs and the Veterans Administration (VA) home loan guaranty program. Rather, these programs served to prove the actuarial viability of mortgage insurance and amortized, long-term mortgages. Furthermore, FNMA and FHLMC, the principal secondary markets for privately insured conventional loans, provided standardization, which is vitally necessary to the evolution and development of these types of mortgage instruments.

The primary argument being offered to substantiate the exclusion of FNMA and FHLMC from the benefits of S 1822 is that their presence will overwhelm that of private issuers. On the contrary, their presence in the TIMs market will help to ensure its success. While there was a substantial market preference when MBS products were at an experimental state in the 1970s, when the perceived Government backing increased investor acceptance of these new products, this is simply not the situation today. The investment market is well-acquainted with MBS issues, as these products are tested and accepted by a wide variety of investors. Although the TIMs proposal will alter the present form of MBS offerings somewhat, its chief goal will be to build upon the current types of offerings, largely developed by GNMA, FNMA, and FHLMC, by reducing the investment disadvantages and the regulatory burdens of making these offerings.

Furthermore, unlike the private companies seeking to compete for CMBS markets, FNMA and FHLMC, still must fulfill their mandated public purpose goals. The presence of FNMA and FHLMC has advanced rather than impeded the advance of private entities into the secondary market arena. Once these impediments are removed, all competitors can strive against one another to deliver the products that best meet the mortgage credit needs of consumers with different affordability requirements. FNMA and FHLMC should not be excluded from the markets they have worked on diligently to develop. The competitive edge and expertise they bring to the marketplace clearly works to the consumer's advantage.

Primarily, the issue boils down to one of timing. With the presence of such a high level of demand and the current affordability crisis, it appears to us that now is the time to add more actors to the mortgage marketplace, rather than the time to engage in an experiment to test the ability of private entities to replace Government-related entities in vital new markets.

The tremendous prospective demand for residential mortgage credit in this country has drawn the attention of many financial and industrial giants in recent years. Indeed, quite a few financial and non-financial corporations already have begun to establish a market presence. It is MBA's belief that lower interest rates, more than any other factor, are the key to spurring additional private entrants actively into the marketplace. So long as mortgage rates are affordable and demand is present, the market will support competition among a large number of secondary market operations, because volume is the key to success in those markets. The inclusion of the widest variety of players in all mortgage markets will best serve the needs of consumers, who could choose from the widest variety of competitively priced products.

MBA believes that the inclusion of FNMA and FHLMC in TIMs would serve to propel the development of these markets, rather than inhibit private entries. The passage of these initiatives will introduce a new era in mortgage finance, similar to the early 1970s. The federally sponsored instrumentalities will serve as a catalyst to these developing markets, as their presence would provide the standardization and volume that is necessary for CBMSs to attract investor interest. Those two factors are necessary to ensure that the products offered will be liquid and marketable. Furthermore, the participation of FNMA and FHLMC in all geographic markets and during all economic cycles will add much-needed stability to the marketplace and, thus, will serve as a presence that investors may use as a benchmark against which to judge privately backed issuances. This stability still will allow experimental and custom-tailored CMBSs to be marketed, but the market will be able to judge offerings against a standardized version.

During the initial development of CMBS issuances, as well as Adjustable Rate Mortgages and other alternative mortgage forms in the primary mortgage markets, FNMA and FHLMC played a crucial role in standardizing those instruments. Furthermore, market

ability is often tied to the concept of a standardized, accepted instrument. For example, the Employee Retirement Income Security Act (ERISA) places a great deal of emphasis upon market acceptance and ties that concept to Government-type securities. The stabilizing presence of FNMA and FHLMC in the TIMs market would underscore the acceptability of the instruments. An alternative would be to define more closely the types of eligible instruments to achieve the goal of standardization. This, however, could stymie creative approaches or issues that are closely tailored to meet certain regional or local market needs.

The importance of standardizaton is that investors are most attracted to instruments that have large, liquid markets, or that the value of such a holding can be readily determined, and so that the instruments may be readily bought and sold. Inclusion of FNMA and FHLMC in TIMs will ensure the creation of a large, liquid market fairly quickly. That will benefit all participants—consumers, lenders, issuers, and investors.

Another benefit of allowing FNMA and FHLMC to participate in TIMs is that their activity can serve to estabish a benchmark for pricing private issuances and ensure that there is competitive pricing for loans in this price range. The presence of FNMA and FHLMC will simply keep other issuers "honest" by providing another source of competition, contributing to the efficiency of the market.

MBA believes that the residential mortgage market is big enough to accommodate a variety of competitors and, in fact, would be broadened as much as possible so as not to exclude the entities who have had the most experience and success in marketing conventional loans—FNMA and FHLMC. Their inclusion in S 1822 will allow FNMA and FHLMC to fulfill their mandate of expanding the affordability of mortgages to a greater number of consumers.

PROVISIONS OF S 1822

The following comments and suggestions are directed to specific provisions of S 1822.

Qualified Obligations

From the point of view of mortgage bankers, who make loans and originate mortgages in the primary market for sale in the secondary market, perhaps the most important question is what types of mortgages will be involved in the marketplace covered by TIMs. S 1822 describes these mortgages as "qualified obligations." (Sec. 860 E) Initially, it should be noted that second mortgages are included as well as first mortgages, a recognition that second, or junior lien, mortgages are increasingly being accepted as secondary mortgage market instruments. Also, the bill recognizes the various forms in which the secondary market trades these mortgages, e.g., in the form of participations or other instruments. Nevertheless, the mortgages covered would appear to be more narrowly defined than desirable or necessary.

Mortgages on Residential Rental Property

Multifamily. Mortgages on multifamily rental projects should also be classified as qualified assets of a TIM. There is an urgent need for rental housing in many cities that is exacerbated by the lack of financing alternatives available to multifamily developers. There has been a virtual shutdown of Federal subsidies for multifamily rental production and shortages of new multifamily housing are occurring, because very little of this type of development is currently taking place.

Extension of the qualified assets provision to multifamily projects would provide increased financing alternatives that can help to alleviate multifamily housing shortages by seeking conventional or private sources of credit.

Single Family. Similar arguments can be made for including non-owner occupied single family housing as eligible for inclusion in a TIMs. During periods of high interest rates, rental housing is often the only affordable option for a family seeking shelter. While homeownership is a laudable goal, it may be unattainable for many families, who must rely on adequate suplies of rental housing. Single family, investor-held properties are often an important additional source of rental housing and, therefore, should be included as qualified assets.

Definition of Single Family Mortgage. Section 860E (b) (2) cites Sections 103A (1) (9) and (10) of the Internal Revenue Code to define a single-family residence. Sections 103A (1) (9) and (10) are designed to regulate mortgage subsidy bonds and are not an adequate definition for the purposes of S 1822. This definition would prohibit a TIMs from holding mortgages on 2-to 4-unit residences that have not been occupied for the previous five years. Therefore, mortgages secured by new 2- to 4-unit residences would not be eligible. In order to encourage new construction, all 1-to 4-unit residences should be included within the definition of single-family mortgages.

In addition, in order to be qualified, the mortgage must be secured by property "which is (or can reasonably be expected to become) the principal residence of the mortgagor." (Sec. 860E (b) (1) (A).) As noted earlier, MBA believes that the TIMs legislation should encompass rental as well as owner-occupied residential property, but if the occupancy rule is to be retained, it should be modified so that the restriction is operative at the time the loan is made. The TIM has no practical way of policing a homeowner's activity. It

cannot prevent the owner/mortgagor from renting the home to another, thereby causing the investment to fail the test for qualified obligations.

Mortgage-Backed Bonds. Section 860E (a) (3) states that a cash flow, mortgage-backed bond is a qualified obligation, however the nature of this instrument is not defined. There are many mortgage-backed securities in use today that are similar to bonds, but are not bonds because the timing of principal repayment is not scheduled. MBA recommends that the term mortgage-backed bond be clarified to include these instruments.

Manufactured Housing. Section 860E (b) (2) fails to include certain types of manufactured housing that currently are eligible for FHA insurance. Generally, FHA insures those types of manfactured housing that are affixed to the lot. MBA recommends that mortgages secured by certain manufactured housing be made eligible for a TIM to hold.

Loan to Value Ratio. Section 860E (b) (3) prohibits mortgages that exceed the value of the residence. This subsection would disqualify several popular mortgage tools, particularly certain mortgages where there is no downpayment and part of the closing costs are built into the mortgage, thereby exceeding the value of the home. This is common with VA loans. MBA opposes this provision and recommends that this provision be amended to allow all mortgages, even if they exceed the value of the residence.

Construction Loans. Section 860E (b) (4) prohibits construction loans. MBA believes that construction loans should be permitted, especially in cases where the construction loan is to be converted into a long term mortgage.

Original Issue Discount. Section 860E (b) (5) prohibits the holding of mortgages "originated with an original issue discount" except where permitted by regulation. This

provision is unclear but would appear to leave a great deal of discretion to the Secretary of the Treasury. The legislation's intent should be clarified.

Taxation of Reinvestment Proceeds

Section 860C (b) (2) requires that any gain or loss realized by the TIM upon the disposition of any qualified obligation and the reinvestment of the proceeds be treated as a distribution to all shareholders as if each shareholder received the income. One of the purposes of a TIM is to allow the TIM actively to manage its portfolio. This provision burdens the reinvestment transaction with income taxes to the shareholders. If the TIM cannot reinvest the proceeds of a disposition without a taxable event, the ability to manage the TIM is restricted. The reinvestment of proceeds of a disposition should be treated in the same manner as a corporation that reinvests its income. The shares in the corporation may increase in value but the shareholders are not taxed until they sell the shares.

Transfer of Mortgages to Tims

Section 860 D provides that a person transferring a mortgage to a TIMs in exchange for an equitable interest in the TIM shall recognize the difference between the transferror's basis and the current fair market value ratably over the remaining term of the mortgage. This proposal recognizes an essential concept: that the originators of mortgages must not be required to recognize a taxable gain upon and at the time of the exchange of mortgages for beneficial shares of the TIMs. The experience of mortgage bankers in the GNMA-MBS program makes clear that an essential element in market timing is the ability to convert mortgages for the more marketable MBS freely and without severe tax impact.

This ability to transfer the form of a mortgage bankers' beneficial ownership from the borrower-responsive primary market instrument, the mortgage, to the investor-responsive secondary market instrument, the mortgage-backed security, is the key to the securitization of the secondary market and would be hampered if the exchange resulted in a requirement to recognize a gain (or loss) at that point.

Ownership and Control

In combining approaches taken elsewhere in the Internal Revenue Code to corporations and to partnerships, S 1822 leaves ambiguous the nature of the beneficial ownership and of the control which shareholders may have in a TIMs. Assessing shareholders pro rata for the undistributed gain from disposition of a qualified obligation and the reinvestment of the proceeds (Sec. 860C), would appear to assume that the shares are equal, with equal rights to interest income and asset disposition gains. Imposing special treatment on owners of 20 percent or more of the shares (Sec. 860B) would appear to assume that effective control can be exercised by such a shareholder, when, in practice, control may be divorced from a beneficial interest, as it is in non-voting stock of a regular corporation.

TIMs can provide an opportunity for a wide variety of structures, as is recognized in the first subsection of the bill, Sec. 860A (a) (1). The relationships between the TIMs and those who hold securities issued by the TIMs should be allowed to range from that of a bondholder, whose interests are defined in the bond, to a general partner, whose fortunes rise or fall with the market success of the projects. The restrictions imposed on shareholders by S 1822 do not appear to recognize the differences that can be desirable among shareholders of a TIMs. MBA suggests that additional precision be exercised in defining the characteristics of shareholding that will give rise to tax consequences.

CONCLUSION

The secondary market for mortgages has become an important source for real estate finance. The growth in sophistication of the market has reached a point where current tax and securities laws are impeding improvements in efficiency. MBA believes that the concepts embodied in S 1822 and its companion, S 1821, would improve the secondary market.

MBA appreciates the opportunity to testify and would be pleased to furnish additional information, if needed.

Senator DANFORTH. Mr. Levy.

STATEMENT OF GERALD LEVY, PRESIDENT OF GUARANTY SAVINGS AND LOAN ASSOCIATION, MILWAUKEE, WIS., AND CHAIRMAN, TASK FORCE ON MORTGAGE SECURITIES, U.S. LEAGUE OF SAVINGS INSTITUTIONS, WASHINGTON, D.C.

Mr. LEVY. Mr. Chairman, I am Gerald Levy of Milwaukee, Wis. I am here representing the U.S. League of Savings Institutions.

The more flexible trust mechanisms of S. 1822 may hold some potential for supervised savings institutions. Under TIM's you can market securities with multiple maturity ranges appealing to different investors and provide the equivalent of call protection.

TIM's could possibly help in our efforts to restructure and avoid a repetition of the thrift crisis in 1981 and 1982, and there might be some additional opportunities for smaller savings institutions. But even without TIM's, the market for mortgage-backed securities is booming, and savings institutions are serving home buyers in record lending volumes.

We ask you to proceed cautiously in encouraging the participation of unregulated entities in mortgage finance through TIM's, remembering the problems for investors in the housing market created by REIT's and unregulated dealers in Ginnie Mae passthrough securities. In that regard, we would endorse the suggestion of Vice Chairman Martin of the Federal Reserve, that the Federal Home Loan Bank Board, as the primary regulator of home financing intermediaries, be charged with the establishment of minimum standards for TIM's sponsors. Net capital standards for nonregulated financial intermediaries may be appropriate.

My full statement offers specific comments on the bill. We would like to respond further for the record on Treasury's testimony, which was not available to us in advance.

Senator DANFORTH. Fine. We would welcome that and any written comments you would care to make.

Mr. Tuccillo?

[Mr. Levy's prepared statement follows:]

STATEMENT OF GERALD J. LEVY

ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

TO THE SENATE COMMITTEE ON FINANCE

November 4, 1983

MR. CHAIRMAN:

My name is Gerald J. Levy. I am President of Guaranty Savings and Loan Association of Milwaukee, Wisconsin, and appear today in my capacity as a member of the Executive Committee and Chairman of the Task Force on Mortgage-Backed Securities of the United States League of Savings Institutions*.

The League appreciates this opportunity to present its views on S. 1822, the bill by Senators Tower and Garn to authorize TIMs -- Trusts for Investment in Mortgages.

---

*The U.S. League of Savings Institutions, formerly the U.S. League of Savings Associations, has a membership of 3,500 companies representing over 99% of the assets of the $730 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. Recently, many prominent savings banks have joined the League as members. The principal officers are: Leonard Shane, Chairman, Huntington Beach, California; Paul Prior, Vice Chairman, New Castle, Indiana; William O'Connell, President, Chicago, Illinois; Stuart Davis, Legislative Chairman, Beverly Hills, California; and Roy Green, Executive Vice President, Phil Gasteyer, Legislative Counsel, and Coleman O'Brien, Associate Legislative Counsel, Washington, D.C. League headquarters are at 111 East Wacker Dr., Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N. W., Washington, D.C. 20006. Telephone: (202) 637-8900.

The purpose of this legislative proposal is to permit the formation of new tax-exempt conduits for attracting funds to home finance through the use of securities backed by conventional mortgage loans. TIMs would expand the number of entities participating in the mortgage delivery system and, to some degree, standardize recent innovations in mortgage-backed securities designed to appeal to a broader range of investors. TIMs would be in addition to the existing real estate investment trust (REIT) provisions in the Internal Revenue Code.

MORTGAGE-BACKED SECURITIES GROWTH

Recently mortgage-backed securities have played an increasingly prominent role in housing finance. In the first nine months of 1983, the Government National Mortgage Association has reported issuing $41 billion in pass-through securities backed by FHA and VA home loans. This activity has been supplemented by securities packaged by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association backed, in most cases, by the conventional home loans which comprise the bulk of mortgage originations. According to one estimate (see article from the October 24 New York Times, attached as Exhibit A), as much as $85 billion in pass-through securities could be marketed this year. In addition, large commercial banks, savings institutions and building organizations have floated bond-type securities backed by mortgages or Ginnie Mae pass-throughs. We understand that

over 40 issues are currently "in the pipeline" awaiting bond ratings from the companies which provide that service.

Despite this tremendous burst of activity in "securitized" mortgages, the authors of TIMs perceive a need for streamlining the process through the creation of the limited-purpose tax-exempt trusts for mortgage investment. The existing mechanisms, particularly the pass-through instruments, are poorly suited to some of the characteristics of long-term home mortgages -- where cash flow may be interrupted, and loans prepaid at erratic intervals. To avoid double taxation of both securities holder and the trust conduit, current mortgage-backed securities utilize (under existing tax law) passively-managed "grantor trusts" where there is little ability for the trustee to manage assets and the certificate holder receives an undivided proportionate interest in the mortgages pooled to support the securities issue. When mortgaged homes are sold, and loans prepaid, there is no opportunity for the trustee in a grantor trust to substitute other loans. This creates a lack of "call protection", which is a handicap in attracting bond market investors to these products, since the uncertainty of prepayment carries with it the possibility of having to reinvest paid-off securities at unpredictable times. The maturity of the investment under the grantor trust is also considered to be that of the longest mortgage in the underlying pool -- which generally confines potential investors to those active in the long-term debt markets.

THE TIMs PROPOSAL

According to the sponsors of S. 1822, "The TIMs legislative proposal is intended to resolve the problems of the grantor trust by creating a new form of flow-through entity for mortgage securities allowing for call protection and for multiple classes of securities."

Another purpose inherent in the TIMs design (as set forth in S. 1822) is to encourage greater private sector involvement in the developing mortgage-backed securities market -- a marketplace now dominated by GNMA, FNMA and FHLMC, all federally-sponsored entities with a variety of governmental supports which enable them to attract investors to their products at preferential yields. TIMs will permit strictly private-sector entities to attract funds to mortgage finance at yields which approach those of comparably-rated corporate issues, if not those available to the agency-sponsored securities. Some of the savings made possible through more efficient marketing of conventional mortgage-backed securities will theoretically be passed along to home buyers.

CURRENT CONDITIONS AT SAVINGS INSTITUTIONS

The increased use of mortgage-backed securities to provide mortgage credit is, of course, a departure from the traditional reliance on hometown, specialized depository institutions, such as the savings and loans associations and savings banks represented by the U.S. League. Our supervised institutions have been the principal source of housing credit for decades and have performed the primary financing role that has made America a nation of homeowners. Savings institutions remain committed to home finance. Indeed, with the relaxation of interest rates in the winter, spring, and summer of this year, we originated the greatest volume of home loans in our history. According to the Federal Home Loan Bank Board, our associations closed $13.5 billion of mortgage loans in August (latest figures available), up from $12.6 billion in July and only slightly less than the record $13.9 billion in June -- while commitments to originate for the first eight months of the year totalled $88 billion.

Through the use of new mortgage instruments, such as the adjustable rate mortgage, and innovative use of mortgage-backed securities, our private-sector institutions are anxious to continue to participate in the housing delivery process. Many of our institutions, of course, will continue to emphasize home mortgages as portfolio investments. There are important public benefits to our continued participation as portfolio investors

in mortgages -- not the least of which are the availability of funding for new mortgages in periods of stress provided by the repayment flows from portfolio-held mortgages.

Your Committee is aware, I'm sure, that the past three years have not been easy ones for savings institutions. When interest rates skyrocketed we encountered a classic mismatch of our long-term assets and our short-term savings account liabilities, resulting in two successive years of substantial earnings losses. One-fifth of our reserves -- accumulated overhalf a century -- were destroyed, and hundreds of hometown thrift institutions were merged out of existence. We must continue to cope with some very sobering statistics: 55 percent of the mortgages on our books are earning less than 10%, and 30% are under 9%. Many of these loans have 20 and 25 years left until maturity. Despite the record volumes of new lending in recent months, no more than 20% of our portfolios earn above 12.5%.

Overall, our portfolio yield today is 10.6%. Our cost of money, reflecting the upswing this summer in short-term money rates, is near 10%, giving us an operating spread of less than 1%. While this is a vast improvement over a year ago, when the spread was a negative 1%, it is not enough to compete very effectively and rebuild net worth. And, it is far below the historical 1.75% spread under which our institutions operated successfully for decades.

Our home finance institutions remain in a fragile condition today -- exposed to renewed losses if interest rates should suddenly move upward again. On October 1 all of our time deposits were deregulated while, as indicated, progress is slow in working our way out from under the legacy of low-yielding loans in our investment portfolios.

In addition to our efforts to restructure through the marketing of adjustable-rate mortgages to new loan customers, our institutions have also been aided by the Garn-St Germain Depository Institutions Act of 1982, P.L. 97-320, enacted by the last Congress. The preamble to that landmark legislation stated as its purpose: "To revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans." We are trying our very best to see that these goals are accomplished. To the degree that S. 1822 can speed the restructuring process, it can be of great assistance to our institutions -- and to the Federal Home Loan Bank Board which functions as steward of the Federal Savings and Loan Insurance Corporation fund and the Federal Home Loan Bank System as its supervisory tasks.

The TIMs concept was first explored, to our knowledge, in the work of the President's Commission on Housing in 1981 and 1982 -- at the depths of the thrift institution crisis and near the peak of the interest rate explosion (and the accompanying collapse of the housing sector). Perhaps as a result, in its Report published in late April, 1982, the Commission observed:

> "Clearly the nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met. A new legal and regulatory structure should be developed, and a broader-based, more resilient system of housing finance is essential. In the future, resources to finance housing should be provided by unrestricted access of all mortgage lenders and borrowers to the money and capital markets, and mortgage market participants should have reliable methods to manage interest rate risks. Sweeping policy measures to change the structure of the housing finance system are essential." (at page 12J)

Subsequently, in its Chapter on "Broadening Private Sources of Mortgage Credit", the Commission focused on tax code, securities law, bankruptcy act and State blue-sky barriers to expansion of conventional mortgage-backed securities. The tax code recommendations were the precursor for the TIMs proposal which we are discussing this morning.

In light of intervening events -- including the new foundation for recovery of thrift institutions provided by the Garn-St Germain Act, the growing public acceptance of new mortgage instruments, and the proven ability of our institutions in recent months to resume high levels of mortgage lending activity -- we must question the urgency of "sweeping policy measures to change the structure of the housing finance system". I would also note, as described in Exhibit A, that even without the TIMs proposal, the marketplace for mortgage-backed securities is expanding rapidly in imaginative and interesting ways.

TIMs, of course, will open even further possibilities for

packaging mortgages, issuing securities against them, and designing mortgage-backed instruments which might appeal to investors who have heretofore shied away from housing finance. Of particular interest is the ability to create multiple maturity classes from a single mortgage pool and manage uneven cash-flow arising from the loan payments of homeowners. (A collateralized mortgage obligation issued earlier this year by the FHLMC successfully attracted pension fund, insurance company, and savings institution buyers for long, medium, and short segments, respectively.) As mentioned, TIMs could be especially helpful if products could be designed to monetize and "put to work" some of the below-market loans held in thrift portfolios -- thus speeding the restructuring of our institutions.

CAUTION NEEDED

At the same time, the Congress in our view would be well advised to proceed deliberately to be certain that new mortgage delivery mechanisms do not undermine existing mortgage sources or encourage haphazard housing activity. As this Committee is well aware, the REIT change in the tax code led to significant overbuilding in 1973-74 and some serious financial failures. Housing finance-specialized thrift institutions, as explained above, are still in the early stages of recovery from the ravages of 1980, 1981, and 1982, and the exposure of the federal insurance-of-accounts funds -- backed by the full faith and credit of the United States -- remains significant.

Advocates of TIMs also cite the promise of significantly lower mortgage rates for homebuyers. The savings institutions industry is strongly supportive of innovations which make homeownership and mortgage credit more affordable for American households. However, the anticipated reduction in mortgage rates from the presumed efficiencies of TIMs is an untested proposition. If a rush of TIMs issues drives down market rates initially, and in the process drives out traditional hometown sources of mortgage credit, the longer-run effect could be to concentrate mortgage finance in fewer providers. Under that scenario a lasting benefit to homebuyers is by no means a certainty.

In addition, the design of S. 1822 does not differentiate among possible TIMs participants -- as mortgage originators, directors, trustees and issuers -- or establish standards for their supervision. As closely-supervised lending institutions specializing in mortgage finance, we are concerned about an open invitation to unregulated entities to provide mortgage credit through these new trust mechanisms.

On this point, I would like to call to the Committee's attention some recent testimony by Preston Martin, Vice Chairman of the Board of Governors of the Federal Reserve System. Dr. Martin has long been recognized as a leading authority on housing finance, and, prior to his current federal post, was a member of the President's Housing Commission. On September 22, he testified about S. 1822 before the Senate Banking Committee, as follows :

> "One thing missing in (S. 1822), however, is reference either to quality standards for the "TIM" securities or to supervision of the trustees or managers of TIMs. . . . I am concerned that creation of new types of mortgage investment trusts, that apparently could take a variety of forms (corporate or otherwise) under S. 1822, and that would permit trustees to actively manage the funds entrusted to them by individual investors, would create leeway for bad reinvestment decisions or even for abusive practices by trustees or managers. Such events, of course, could heavily damage all elements of the private mortgage pass-through securities market.
>
> It's difficult to specify at this time, the type of supervisory structure within which TIMs ideally should operate. One possibility would be to require that TIMs be subject to the types of controls established for mutual funds registered under the Investment Company Act of 1940 -- other entities with flow-through tax treatment under the Internal Revenue Code.
>
> Another possibility would be to involve Federal agencies with considerable expertise in housing finance, such as the Federal Home Loan Bank Board, in the supervisory process."

In addition to the concerns raised by Governor Martin, the Congress should examine these proposals from the perspective of investor protection. In December 1980, the Securities and Exchange Commission, the Federal Reserve and the Treasury submitted to the Senate Banking Committee a detailed study on abusive practices by unregistered issuers and dealers in the marketplace for Ginnie Mae pass-through securities. The study documented various problems which had arisen in the late 1970s -- including overcommitments in connection with forward transactions, misuse of customer funds and securities, churning, and questionable sales practices by issuers and dealers. Several unregistered dealer firms collapsed, with an adverse impact on mortgage yields generally. The victims

included a major university and several depository institutions which had been induced to speculate on interest-rate movements through sizable Ginnie Mae forward contracts. (Subsequently, the Federal Home Loan Bank Board and other financial regulatory agencies placed strict controls on all forward commitments by the depositories under their jurisdiction.) Analogous problems arose more recently in the unregulated market for repurchase agreements with the failures of Drysdale Securities, Lombard-Wall and Comarc.

While we would certainly hope that the problems detailed in the study for Ginnie Mae mortgage-backed securities would not be repeated as the market develops for TIMs backed by conventional home loans, we would recommend a careful reexamination of the Treasury-SEC-Federal Reserve study with that possibility in mind. If investor confidence is to be achieved in a broadened marketplace for mortgage-backed securities, it is vital that adequate standards be included. Otherwise, these promising developments could hinder, rather than enhance, the quest to attract new sources of credit for housing.

Before proceeding to discuss particular provisions in S. 1822, we would also note that this legislation does not stand in isolation. As the President's Housing Commission recognized, a total approach to broadening the securities market for products backed by conventional home loans requires changes in the Securities Acts of 1933 and 1934, the Bankruptcy

Act, and the Banking Act of 1933 (Glass-Steagall), and State statutes governing "legal list" investments by trustees and "blue-sky" securities registration laws. Some of the changes, but by no means all, are under consideration in the Banking Committee (S. 1821, the Secondary Market Enhancement Act), and others will be affected by such forthcoming recommendations as those of Vice President Bush's Task Group on Regulation of Financial Services.

We would now like to make some specific comments about the language of S. 1822 as introduced and referred to your distinguished Committee. It is our understanding that the Treasury Department does not endorse S. 1822 and will be offering significant changes during the course of the legislative process. Those changes are not available at the time this testimony is being prepared, and we would like to reserve an opportunity to comment further when they are submitted to the Committee or the United States Senate.

Section 860E(e) -- This section provides for an 18-month period during which the incorporated TIM may acquire a wide variety of short-term investments while maintaining its tax-exempt status in preparation for its issuance of mortgage-backed securities backed by home loans. In effect,the provision invites the operation for a year-and-a-half of a money market fund -- but without any pattern of regulation and very little restriction on the types of investments made during this formation period. According to the section-by-section

summary accompanying S. 1822, the purpose of this 18-month formation period is to "provide cash to meet fixed obligations or to provide income to the TIM to offset income lost because of prepayment or liquidation." Certainly 18 months is grossly excessive for this purpose -- especially in light of the extended shelf registration treatment recommended in the companion S. 1821 legislation. In addition to the virtually unfettered operation of a tax-exempt money fund, other abuses are possible. For instance, arguably a construction firm could utilize the proceeds of a securities sale at time of incorporation to fund the building of a condominimum through this tax-exempt intermediary -- and recreate some of the REIT-type problems encountered ten years ago.

The U.S. League strongly recommends that the 18-month income investment period be shortened significantly, and that the list of qualified short-term investments be spelled out with greater precision. Certainly the period should be no longer than the 120 days provided for forward placement under the Securities Act changes found in S. 1821, the Secondary Market Enhancement Act reported recently by the Senate Banking Committee.

Section 860E(b) -- This provision defines the first and second mortgages eligible for pooling in the TIM when it becomes operational. Since the TIMs concept is designed to attract credit for conventional mortgage credit at more favorable terms, we would suggest that FHA-insured or

VA-guaranteed home mortgages be excluded from eligibility. However, we do not understand why the language, as written, makes conventional graduated-payment mortgages (or possibly adjustable-rate mortgages generally) ineligible for TIMs (since they are "originated with an original issue discount").

Section 860C(c) -- In the general rules governing treatment of dispositions of qualified obligations by the TIM, the character of realized gains (after allocation of principal to shareholders) is preserved. However, the language in this section dictates that where a TIMs shareholder is a "domestic building and loan association" utilizing Section 593 of the Internal Revenue Code, the gain on disposition of a qualified obligation must be treated as ordinary income. When a savings institution participates as an investor-shareholder in a TIM, we do not understand why this special and discriminatory treatment is justified. Indeed, the language of S. 1822 should be clarified to assure that income derived by a domestic building and loan association (or mutual savings bank) from investment in a TIM, as with its other mortgage investments, is specifically eligible for Section 593 treatment.

Section 860D -- The language here provides the tax accounting treatment for contributing shareholders to a TIM. It dictates that a cost basis will be used and gains or losses recognized ratably over the remaining term of the loans contributed. The language apparently contemplates that TIMs will only issue equity shares to such contributors. It is also

possible to utilize the TIMs mechanism by having the trust issue liabilities (debt) to contributors. For financial accounting reasons, debt issuances would be especially appropriate in cases where older, below-market mortgages are contributed to these trust mechanisms. Guidance is needed on how that might be treated for tax accounting purposes.

As a final matter, we would suggest that in your consideration of S. 1822, Section 7701(a)(19)(C) of the Internal Revenue Code be amended to include the mortgage assets held by a TIM which is a financing subsidiary of a savings institution to qualify as eligible investments for meeting the definitional tests for a domestic building and loan asssociation.

* * *

This concludes the written statement of the U.S. League of Savings Institutions. The League has appreciated this opportunity to present its views on S. 1822, the Trust for Investments in Mortgages legislation. I look forward to your questions.

###

31-489 O—84——10

EXHIBIT A

THE NEW YORK TIMES - 10/24/83

Mortgage-Backed Securities Surge

By MICHAEL QUINT

Corporations are reluctant to sell long-term bonds and the Treasury's borrowing needs are declining, but the issuance of mortgage-backed securities is setting records and attracting new investors.

The business of packaging home mortgages and selling them as securities is 14 years old. But is is now in the midst of major changes as the housing market revives from the depressed years of 1980-82.

"This year marked the onset of a revolution in securitizing residential mortgages," said Joseph Hu, a housing economist at Salomon Brothers. In a recent speech, Mr. Hu said that more than 40 percent of the home mortages originated this year have been packaged as securities, more than double the percentage of any previous year.

New Methods of Packaging

When savings and loan associations were forced in recent years to pay fluctuating market rates of interset for their deposits, they became less willing to own fixed-rate mortgages. To distribute the mortgages no longer wanted by the traditional buyers — savings and loan associations — Wall Street firms, homebuilders and Federal agencies have devised new ways of packaging the mortgages into securities that are more attractive to investors, such as pension funds.

While "securitizing" is not a word that will be found in the dictionary, it is a prominent new entry in Wall Street's lexicon. As the creation of mortgage-backed securities proceeds at a record rate, more firms are trying to get into the business.

Smith Barney, Harris Upham & Company recently decided the best way to become a force in the business was to hire a group of four officials from Merrill Lynch, led by Leonard A. Tancona. Morgan Stanley & Company also wants to play a bigger role, market participants said.

The mainstay of the mortgage-backed market has been the Government National Mortgage Association, known as Ginnie Mae, which issues pass-through certificates backed by pools of home mortgages assembled by mortgage bankers.

During the first nine months of this year, Ginnie Mae has issued $41 billion of pass-throughs, with more than $5 billion in some months. The corporate bond market has averaged slightly more than $3 billion of new issues a month this year.

According to Mr. Hu, more than $55 billion of mortgage-backed pass-through securities could be sold this year, nearly triple the previous record of $19 billion in 1979. The volume of Ginnie Mae issues is now heavily supplemented by those of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association, both of which exchange their securities for mortgages, and also accept pools of conventional home mortgages.

The Ginnie Mae pass-throughs, whose yields have averaged about 67 basis points, or hundredths of a percentage point, more than 10-year Treasury notes over the past three years, are the only pass-through issues backed by Government.

Despite the Federal backing, and the high credit quality of other issues, they have been avoided by some potential investors because of uncertainty about the size of the monthly payments of principal and interest that are passed through from the homeowner to investors.

When interest rates decline and home sales rise, more mortgages are pre-paid, which reduces the average life of pass-through issues. The opposite occurred during 1980-82, when interest rates were high and the housing market was depressed.

Lack of Familiarity

"For most pension funds, a mortgage is a rather foreign instrument," said Thomas S. LaMalfa, manager of secondary market research at the Mortgage Guaranteed Investment Corporation. The new kinds of mortgage-backed securities, plus legislation currently before the Senate "are ways for all kinds of mortgages to compete in the capital markets for the same investor dollars as the Treasury and corporations."

The most notable of the new kinds of securities have been bonds collateralized by Ginnie Mae pass-throughs, which are becoming popular with homebuilders. The Pulte Corporation recently registered a $1 billion issue, and the American Southwest Financial Corporation, owned by 22 homebuilders, recently sold a $413 million issue.

These bonds are backed by pools of Ginnie Mae pass-throughs, whose monthly payments of principal and interest are managed and temporarily invested so that the securities only pay interst semiannually. The bonds have various maturities, with all principal payments from the Ginnie Mae pool going to retire the shortest-dated issue.

Another new security is the collateralized mortgage obligation of the Federal Home Loan Mortgage Corporation, which offers three maturities with more certainty of cash flow than for Ginnie Mae issues. These securities collect interest and principal payments from an underlying pool of mortgages, and the agency promises to dip into its own funds if needed to make the semiannual payments of principal and interest.

The legislation referred to by Mr. LaMalfa is known as the Trust for Investments in Mortgages, and has the enthusiastic backing of securities dealers and the savings and loan industry. By revising certain tax and legal barriers, the law would permit savings and loan associations and others to manage the cash flow from pools of conventional home mortgages, allowing mortgage-backed securities to be sold with more certainty about maturity and interest payments.

STATEMENT OF JOHN TUCCILLO, VICE PRESIDENT FOR ECONOMICS AND RESEARCH, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS, WASHINGTON, D.C.

Mr. TUCCILLO. Mr. Chairman, my name is John Tuccillo, and I am vice president and director of research and economics for the National Council of Savings Institutions. During 1981 and 1982 I was a member of the senior staff of the President's Commission on Housing, and during that time participated in the development of the TIM's concept.

The National Council strongly supports S. 1822, since it will create shorter term mortgage-backed securities that will be ideal assets for thrift institutions. Asset management for savings institutions is much more difficult in our current deregulated environment, and mortgage-backed securities offer thrift managers many more options than do the mortgages themselves.

In spite of the existing limitations of mortgage-backed securities, thrifts have been turning to them in ever-increasing amounts. Last year thrifts converted mortgages into securities in such volume that over 90 percent of the business of the Federal Home Loan Mortgage Corporation was devoted to these transactions, known as SWAP's. Between 1978 and 1982, the percentage of mortgage-backed securities as a part of mortgage-related assets doubled for mutual savings banks to 18 percent and almost tripled for savings and loan associations, to 14 percent.

Passage of S. 1822 will expand the options for thrift diversification and enable thrifts to better manage their assets for continuing their major role in housing finance. An expansion on these comments is found in my written statement which I will submit for the record, which also, I might add, contains a reiteration of our endorsement for your bill, Senator, S. 1147, the Mortgage Debt Forgiveness Tax Act, which the council strongly supports as a measure which would introduce equity into the prepayment process.

Thank you.

Senator DANFORTH. Thank you very much.

[Mr. Tuccillo's prepared statement follows:]

Statement
of the
National Council of Savings Institutions
on S. 1822
before the
Committee on Finance
United States Senate
November 4, 1983

Mr. Chairman, my name is John Tuccillo and I am the Vice President and Director of Research and Economics for the National Council of Savings Institutions. As you may have heard, our association has recently been formed by the consolidation of the National Association of Mutual Savings Banks and the National Savings and Loan League. We represent over 600 savings banks and savings and loans with total assets of $300 billion.

Since we represent lenders very active in the residential mortgage market, the Council supports passage of S. 1822, or similar legislation to remove statutory impediments to the development of a broad range of mortgage-backed securities. We have testified before the Senate Banking Committee in support of a companion measure, S. 1821, which that Committee has reported to the full Senate. You are to be commended for beginning the work on the major tax issues affecting the secondary market by holding these hearings, and we look forward to working with the Committee in the future on this legislation.

When the President's Commission on Housing published its report in the Spring of 1982, it listed several statutory and regulatory problems confronted by privately-issued mortgage-backed securities (MBS). The report noted:

"mortgage-related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations."

The report recommended several specific regulatory and legislative actions, and some of these regulatory changes have already been made:

-- The SEC has allowed "blind pools" which enable securities to be sold before the actual mortgages are made;

-- The SEC has allowed "shelf registration" for multiple issuances of similar MBS; and,

-- The Federal Reserve Board has amended Regulation "T" to allow MBS to be purchased on margin.

While these regulatory changes have substantially improved the climate for the development of private MBS, tax law, requiring legislative action, still constrains the process. S. 1822, Mr. Chairman, follows through on the recommendations of the Commission's report, and I can say that the National Council strongly supports this effort.

Why is it important for financial institutions to be able to have a wider range of options with respect to mortgage-backed securities? The answer is that flexibility, manageability, and liquidity of assets are crucial to the successful functioning of depository institutions today. The financial crisis faced by the thrift industry was brought on in large part due to our excessive reliance on long-term, fixed-rate mortgages. These assets continue to stay on our books as the cost of our funds has risen to historical highs, and these mortgages simply do not lend themselves to the complexities of today's financial marketplace. Adjustable rate mortgages are part of the answer but they are not the total solution.

The need for more manageable assets has been brought about by technological, market, and statutory changes that have made the flow of funds to thrifts a shorter-term, less predictable and more expensive phenomenon. According to figures of the Federal Home Loan Bank Board, the national average cost of funds to S&Ls insured by the Federal Savings and Loan Insurance

Corporation was 6.79% for the six-month period preceding January 1, 1979, 7.71% in 1980, 9.11% in 1981, and 11.53% in 1982. Even now, with rates having fallen, that cost of funds stands at 9.81%. Now that the Depository Institutions Deregulation Committee has completed its schedule for the removal of interest rate regulations on time deposits, consumer expectations and competition from new players in the financial services industry will soon result in full deregulation of the deposit-taking business.

In spite of the existing limitations on private mortgage-backed securities, thrifts have been moving to alter the form of their mortgage investments in increasing amounts. Last year, thrift institutions converted old mortgages into securities in such volume that over 90% of the business of the Federal Home Loan Mortgage Corporation (FHLMC) was devoted to these transactions known as SWAPs. In fact, the total volume of new securities formed from old mortgages last year was $32 billion. Why do institutions convert (or securitize) their mortgages, a transaction which does cost money? The answers are that securities can be sold more quickly and with shallower discounts than mortgages, they can be used as collateral for certain loans, and they offer asset managers other options. These reasons recently led Financial Corporation of America to enter in a $2.6 billion SWAP with FHLMC, the largest in the two-year history of these transactions.

The use of securities, particularly in conjunction with newly-issued mortgages, also lends itself to risk management through hedging activities such as futures and options. Government National Mortgage Association (GNMA) mortgage-backed securities have been traded in the futures markets for several years, and similar facilities are developing for conventional mortgage-backed securities. As thrifts attempt to match assets and liabilities in a world

where the cost of liabilities can change on a daily basis, the increasing use of securities related to mortgages will be a part of solving this complex problem.

The experience with GNMA securities shows how effective securities can be, if they are structured to provide adequate soundness and yield to investors. Approximately 90% of all FHA and VA single-family mortgages originated last year were funded through the sale of GNMA MBS. While the comparable percentage for conventional mortgages funded with securities is relatively small (5% of conventional mortgages originated last year were funded through the sale of FNMA and FHLMC securities), it must be remembered that conventional mortgage-backed securities are in the early stages of growth.

Between 1978 and 1982, the percentage of MBS as a part of mortgage-related assets (mortgages plus MBS) doubled for mutual savings banks (from 9% to 18%) and almost tripled for savings and loans (from 5% to 14%). But, the vast majority of these securities have been in one way or another linked to the federal government. Of the outstanding volume of MBS at the end of 1982 ($183 billion, according to figures of the Federal Reserve), 61% are MBS guaranteed by GNMA, 18% were MBS issued by FHLMC, 10% were Farmer's Home Administration loans sold as pools to the Federal Financing Bank, and 8% were MBS issued by the Federal National Mortgage Association (FNMA).

S. 1822 would establish the statutory foundation to assure the full development of mortgage-backed securities and assist America's homebuying public in finding adequate supplies of mortgage credit in the years to come. Of equal importance, this legislation would enable the private market to supply this capital, by enabling conventional mortgage-backed securities to compete in the capital markets.

S. 1822 is at the heart of the Trusts for Investments in Mortgages (TIMs) concept. The legislation would alter the structure through which MBS are issued to allow active management of the cash-flow generated by pools of mortgages. This is significant because the current treatment of these MBS under the grantor trust provision of the Internal Revenue Code requires that pools be passively managed. Therefore, the issuer of the security must transmit all payments of interest and repayments of principal on a monthly, pro rata basis to all holders of securities. The grantor trust also requires that all securities tied to a specific pool of mortgages represent an equal and undivided share of the assets (the pool of mortgages). All securities backed by the same pool of mortgages must have the same term (which means a fairly long term in the case of issues backed by new mortgages) and they can offer almost no call protection to securities holders.

When these requirements are not followed, the flow of interest is taxed as it goes from the mortgagor to the securities issuer and then again when the issuer transmits that interest to the security holder. This double taxation makes the option of active management prohibitively expensive. Passive management requirements restrict the market for MBS to certain institutional investors.

The benefits of active management have been demonstrated by a recent offering by the Federal Home Loan Mortgage Corporation of collateralized mortgage obligations (CMO's). These CMO's offer investors a variety of maturities in a single issue so that the life of their investment is not totally dependent on the prepayment characteristics of the pool of mortgages. Thus short term CMO will have an average life of 3.2 years, the intermediate term CMO will have an average life of 8.5 years, and the long term 20.4 years. This pattern is achieved by devoting all principal repayments to a single

subgroup of investors at any one time. But, these investments are all linked to the same pool of thirty-year mortgages, and they have the major advantage of appealing to investors that might not be interested in the usual mortgage security, which is limited to one fairly long-term maturity.

S. 1822 also creates a new section in the Code that authorizes and sets guidelines for the establishment of trusts that can issue MBS. Securities backed by a pool of mortgages issued by a TIM may be issued in multiple classes, with varying payment streams, and offer call protection via reinvestment of principal payments from the pool of mortgages.

Basically, the legislation allows TIMs to:

-- use interim assets as collateral to issue securities and then, within 18 months, replace these assets with mortgages;

-- reinvest principal repayments from the pool that would provide call protection to investors when rates drop;

-- establish multiple classes of securities with short-term securities' holders receiving principal repayments before holders of interim and long-term securities; and

-- create bond-like investments with semi-annual payments of interest and payments of principal at maturity.

These steps are certain to make it feasible for new investors to purchase, either directly or indirectly, these housing-related securities, thereby expanding the investor pool from the traditional thrifts and pension funds, to include mutual funds and individual investors.

Under TIMs, as outlined in S. 1822, thrifts could establish their own TIMs and issue MBS secured either by mortgages purchased from other institutions, or originated by the issuer. Thrifts could garner new income from issuing the securities as well as the servicing of the mortgages in the pool. Since TIMs would attract new investors, opportunities for origination and servicing income for thrifts selling to TIMs would also be enhanced. These securities could be sold to institutional investors, such as pension

funds, bank trust departments, insurance funds as well as to retail customers. The net result will be the attraction of new sources of mortgage financing by experienced housing lenders.

On the other side of the transaction, thrifts could also invest in short-term mortgage-backed securities that would be allowed under TIMs. This would help match assets and liabilities, and, as the percentage of housing-related assets continued to shift from mortgages to securities, would lend itself to increasingly sophisticated portfolio management. As thrifts have found in swapping old mortgages for securities, the securities are more liquid and manageable than the mortgages themselves. Since the most important feature of TIMS from the thrift viewpoint is the creation of good, manageable assets, it is important that S. 1822 be amended to assure that any TIM's securities qualify under the tax code for qualified mortgage investments for thrifts (Section 593 of the Internal Revenue Code).

S. 1822 as now drafted excludes FNMA and FHLMC from TIMs. We can certainly appreciate the sponsors' concerns about allowing the private marketplace to develop in as open an atmosphere as possible. However, we believe that the marketplace will benefit from the participation of these established secondary market entities since they will provide a degree of standardization that might not otherwise develop. We only have to look at the last few years with the hundreds of different ARMs to see how the market can be confused by a plethora of instruments. Furthermore, FNMA and FHLMC would speed up the time that the market needs to reach sufficient volume of these TIMs securities to assure full liquidity of these instruments.

Mr. Chairman, your press release announcing this hearing requested testimony on other legislative issues relating to the tax treatment of mortgage investments and I would like to take this opportunity to address two very important matters.

Taxation of Mortgage Debt Forgiveness

I would like to take this opportunity to reiterate our support for S. 1147, the Mortgage Debt Forgiveness Tax Act of 1983, introduced by Senator Danforth. The National Association of Mutual Savings Banks testified in support of this bill last May before the Subcommittee on Taxation and Debt Management and we continue to urge prompt passage of this important legislation. Although the thrift industry is experiencing a modest recovery in the current, more favorable, economic climate, it remains very vulnerable to increases in interest rates. The problems experienced by the industry in the high interest rate environment of the recent past and the cause of our continued concern center on our extensive holdings of low-yielding fixed-rate mortgages. Three-fourths of total savings bank and savings and loan residential mortgages bear rates below 10 percent, and more than one-half of our loans have rates below 9 percent.

Thrifts need a lengthy period of relatively low and stable interest rates to work off low-yielding mortgages and thereby generate the earnings needed to compete in a deregulated environment. To augment this effort, many institutions have embarked on programs designed to encourage borrowers to prepay these older, low-yielding mortgages. Under such programs, the lender agrees to accept an amount less than the total due on the mortgage loan if the borrower agrees to prepay the loan in full, or to substantially increase the monthly payments (and thereby pay the loan back sooner). In short, the borrower is given a "discount" for paying off his loan prior to its scheduled due date.

It is obvious that in order for a program of this kind to be a success, it must offer benefits to both parties. Existing tax law, however, imposes a serious penalty on the borrower, and in turn, acts as a major

disincentive to consumer acceptance. Section 61(a)(12) of the Internal Revenue Code states that the gross income of a taxpayer includes income from the discharge of indebtedness. Section 108 of the IRC provides certain exceptions to this rule, but these do not cover the types of transactions we are discussing this morning. In fact, the IRS has issued rules describing the income tax consequences of a typical situation where a homeowner prepays the mortgage in exchange for a discount, and has ruled that the discount must be treated as taxable income (Revenue Ruling 82-202). The situation is ironic when you consider that third party investors can buy a low-yielding mortgage at a discount and not suffer adverse taxation, but a homeowner cannot.

S. 1147 would address this situation by providing an additional exception to the general rule of IRS Section 61(a)(12) and, in effect, overturn the IRS ruling. The housing and mortgage lending industries strongly support S. 1147 to remove the Internal Revenue Code barriers to the successful operation of programs to encourage the prepayment of low-yielding mortgages. I would like to submit for the record a letter signed by major housing and mortgage lending trade associations in support of this legislation. Such a step not only represents a more logical tax policy, but with banking deregulation proceeding apace, government policy should clearly include maximum incentives for asset restructuring by the thrift industry.

Any revenue loss to the Treasury is more apparent than real because the prepayments would not take place or would be minimal if the discounts are taxed as income. In fact, changing the tax treatment of the discounts on prepaid mortgages could <u>increase tax revenues</u>, and a study supporting this conclusion is attached. Furthermore, such a program will hasten the day when thrift institutions will again pay taxes to the Treasury; it would reduce the possibility that federal assistance would have to be provided to thrift

institutions if interest rates turn up again; and, it will enhance the industry's ability to finance new housing.

Taxation of Bad Debt Allowance

Mr. Chairman, after the recent passage of the Garn-St Germain Depository Institutions Act of 1982 which greatly expanded the asset powers of savings banks and savings and loans, it is now timely to examine the tax treatment of mortgages held as assets by thrift institutions. Under current law, thrift institutions are encouraged to keep the vast majority of their assets in housing-related investments. This incentive is provided by a reduction in taxes paid by savings and loans and savings banks based on their percentage of assets in qualifying mortgage investments.

In light of the new powers authorized by the Garn-St Germain Act and the desire expressed by Congress that thrift institutions broaden their investments, it appears inconsistent to have the tax code work at goals contrary to banking laws. In fact, the President's Commission on Housing reported that "The special bad debt reserve provision can place a significant barrier to asset diversification at thrift institutions."

Mr. Chairman, we urge that the percent of assets required for the Section 593 of the Code be amended to keep in step with the recent major banking laws and the new realities of the marketplace. The current percent of assets requirement is simply too high and should be lowered.

Another issue raised by Section 593 is the unequal treatment of stock savings banks and mutual savings banks. Historically, savings banks have had an asset text level of 72%. Prior to the 1980's mutual savings banks were all mutual organizations.

In 1981, some states began to provide the ability for mutual savings banks to convert to stock form. In view of these developments, a provision

was contained in the Economic Recovery Tax Act of 1981 which granted the BDA to stock savings banks. However, instead of setting the qualifying assets test at the savings bank level of 72 percent, the law mandated that stock savings banks should maintain qualifying assets at the 82 percent level specified for savings and loans.

This higher level asset test for stock savings banks makes no sense. Conversion to stock form does not produce differences in the basic characteristics of investment powers of a savings bank. There are no differences in the purposes or functions of mutual or stock savings banks. In addition, the current provision penalizes and discourages conversion to stock form. This is not a desirable result at a time when thrift institutions need to have all available options to increase their capital base and strengthen their net worth.

At the very minimum, the law should be amended to treat stock saving banks identically to mutual savings banks for purposes of 72 percent asset test.

SAMUEL CHASE & COMPANY
SUITE 200
2000 L STREET, N.W.
WASHINGTON, D.C. 20036
(202) 429-1882
TELEX 440687 TELECOPIER (202) 833-3843

SAMUEL CHASE

July 14, 1983

MEMORANDUM

To: National Association of Mutual Savings Bank, et al.

From: Samuel Chase, John Prather Brown

Subject: Tax Revenues and Mortgage Discount

This memorandum deals with the effect on tax revenues of eliminating or deferring the tax on mortgage interest discounts. We explain below why prepayment of a typical "old" mortgage can be expected to result in an immediate increase in taxable income and show that this increase in taxable income is likely to rise over time thereby generating additional revenues for the Treasury.

We do not deal here with the revenue impact of the tax on mortgage discounts per se. Testimony given last May before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, has shown that taxation of mortgage discounts limits prepayments thereby keeping revenues from the tax on discounts small and also complicating the problems faced by financial institutions attempting to restructure their portfolio. Nor do we deal with indirect benefits (e.g. healthier thrift industry) or multiplier effects (e.g. stimulation of the

housing market) that are frequently cited to rationalize changes in the tax laws.

What we do present here is a straightforward analysis of the likely impact of prepayment of a typical "old" mortgage on the taxable income of a borrower who chooses to prepay.

Such effects may be substantial, because the borrower who prepays his mortgage loses his future mortgage interest deductions. However this view has been criticized on the grounds that funds used for prepayment would otherwise have been used for investment, and thus have earned taxable interest or dividend income.

We believe this criticism is valid, and have taken it into account. Our findings may be summarized simply, as follows: Making reasonable assumptions as to alternative uses of the funds that would be used for prepayment, a mortgage debtor who itemizes deductions will end up with more taxable income if the mortgage is prepaid. That is, when both the loss of interest deduction and the reduction from interest income from funds used to pay off the mortgage are taken into account, taxable income rises. Although the mathematics of the matter is complex, the basic reason is simple: the rate used to discount the "old" mortgage is likely to be higher than the rate earned on alternative investments. Hence, the borrower can increase his net interest

income by prepaying. In consequence, his taxable income is likely to increase.

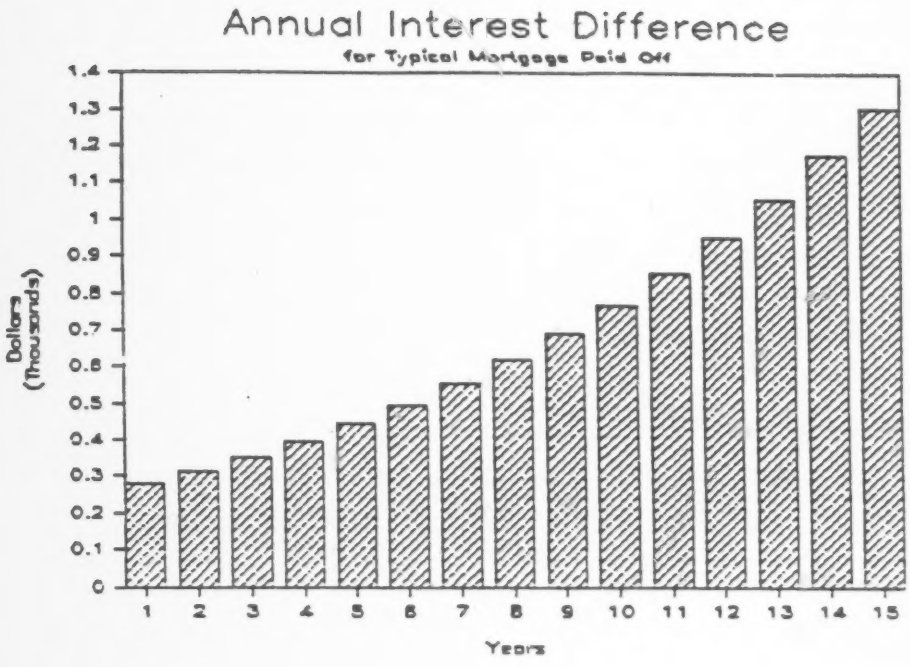
Furthermore, we conclude that the probable increase in taxable income resulting from prepayment is large -- $682 per year on average, in the case of prepayment of a 7.5 % mortgage with 15 years to run and remaining principal of $24,000.

Limitations of time and budget preclude the development of a full blown analysis. We have, rather, based our conclusion on the use of plausible examples. The remainder of this memorandum, including the Technical Appendix, deal with one such example, which we considering to be highly plausible. In this example it is assumed that a debtor is offered the opportunity to prepay a mortgage with 15 years to maturity. This mortgage is assumed to carry a standard rate of interest of 7.5% and to have a remaining principal of $24,000, with monthly payments of $222.48.

We assume that the mortgage debtor has a choice between prepaying the entire balance of the mortgage for $18,051, which represents a discount rate of 12.5% (in line with current mortgage rates) or holding the same amount of funds in a Money Market Deposit Account (MMDA) yielding current interest rates 8.5%.

Great care has been taken in constructing this example to hold other things equal. Specifically, it is assumed that if the debtor pays off the mortgage each month he or she will invest the $222.48 which had been required to service the mortgage.

The effects of prepaying the mortgage on the debtor's taxable income are found by comparing interest income and interest deductions with and without prepayment. The results of this comparison are shown in the accompanying chart. As the chart shows, if the mortgage is prepaid, taxable income will increase, and the increase will become larger with each passing year. The increase in taxable income will rise from $280 in first year to $1,300 in the fifteenth year. Summing the increases for all of the 15 years, taxable income is increased by $10,232, a very large amount when compared to the $24,000 principal or the $18,000 payoff value of the mortgage.



Year	
1	280.43
2	314.90
3	353.17
4	395.63
5	442.72
6	494.81
7	552.73
8	616.75
9	687.61
10	766.00
11	852.69
12	948.51
13	1,054.39
14	1,171.34
15	1,300.48
Total	10,232.23
Average	682.15

Technical Appendix

This Technical Appendix explains in detail the derivation of the chart shown in the text. That chart indicates for a "typical" prepayment of a 7.5% mortgage with 15 years remaining to maturity, the increase in the debtor's taxable income that results from a combined effect of lower mortgage interest deductions and increased interest income.

Table A-1 shows the amortization schedule for the assumed mortgage on a yearly basis, dividing the annual payments of $2670 (i.e. to $222.48 per month) between interest and principal. Annual interest payments declined from $1,769 in year one to $105 in year 15, after which they cease. Over the fifteen years, total interest payments are $16,047. For purposes of this analysis, it is assumed that the taxpayer itemizes deductions and that these payments are fully translated into deductions on the tax return.

Table A-2 shows the yearly interest on a money market deposit account with a beginning balance of $18,051 -- the amount required to prepay the mortgage if the monthly payments are discounted at a rate of 12.5%. It is assumed that, if the mortgage is prepaid, interest will accumulate in this deposit account. Assuming interest is credited monthly, interest income will rise from $1,596 in year one to $5,223 in year 15. Over the

entire 15 year period, interest earnings from this fund total $46,259. For purposes of this analysis it is assumed that all of this interest appears as taxable income for the year in which it is earned.

If the mortgage is not paid off using the $18,051 balance in the MMDA, interest deductions from the mortgage will exceed interest income from the MMDA in the first year, but thereafter, interest income from the MMDA will exceed interest deductions from the mortgage. Table A-3 and the Appendix Chart show the net amounts for each year. These are obtained by subtracting interest payments shown in Table A-1 from interest income shown in Table A-2. This net amount rises over time from -$174 in year one to $5,117 in year 15 as a result of both the decline and interest in deductions as the mortgage is amortized and the increase in interest income as the balance in the MMDA increases. For the entire 15 year period, interest income from the MMDA exceeds mortgage interest deductions by $30,212.

If the mortgage is payed off for $18,051, there will be no more interest deductions attributable to it. Assuming the taxpayer now pays the $222.48 per month into his MMDA which earns 8.5% (and is compounded monthly), interest income less interest deductions will be higher than in the first case, as is shown by Table A-4 and by the top line in the Appendix Chart. It is the difference between the two lines in the Appendix Chart which is shown on the Chart accompanying the text.

If the "old" mortgage rate were higher, or the prepayment price higher (i.e., the discount factor of more than 12.5%), or the rate on the MMDA lowered, the impact income on taxable income will be even greater. Conversely the difference would diminish if the "old" mortgage rate were assumed to be higher, or the prepayment price lower, or the MMDA rate higher. However, it would require odd assumptions to make the difference disappear.

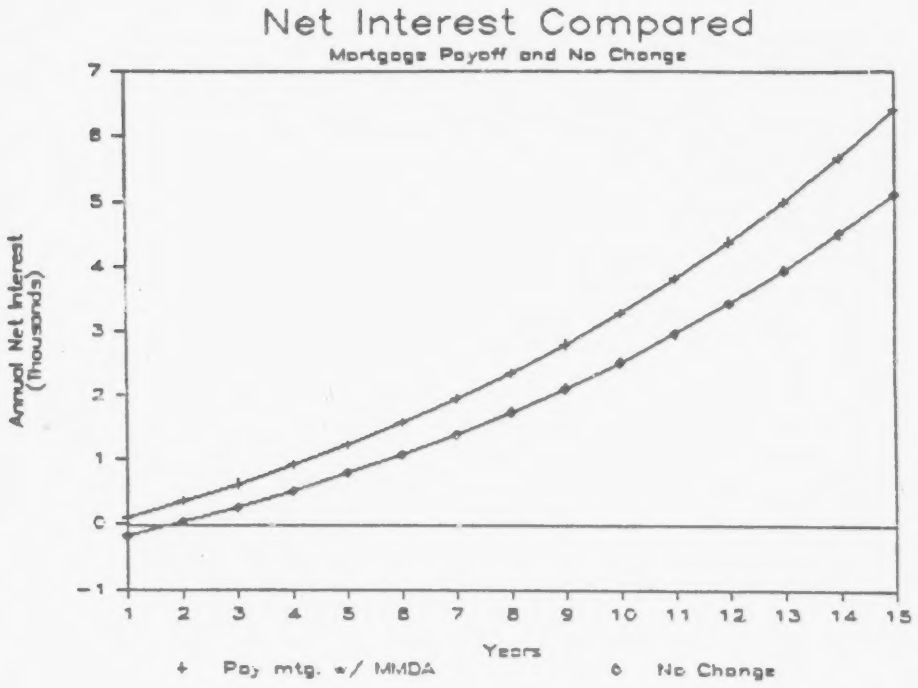

Net Interest Compared
Mortgage Payoff and No Change
Annual Net Interest (Thousands)
7
6
5
4
3
2
1
0
-1
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15
Years
+ Pay mtg. w/ MMDA
o No Change

Table A1
Old Mortgage Amortization Schedule

Mortgage Amount	824,000
Annual Interest Rat	7.5
Term in Years	15
Monthly Payment	222.48

Year	Interest	Principal Repayment	Principal Outstanding
1	1,769.47	800.33	23,099.67
2	1,698.57	870.22	22,129.45
3	1,624.25	1,045.54	21 083.81
4	1,543.09	1,126.71	19,957.20
5	1,455.62	1,214.18	18,743.02
6	1,361.36	1,308.44	17,434.58
7	1,259.78	1,410.02	16,024.56
8	1,150.32	1,519.48	14,505.08
9	1,032.35	1,637.44	12,867.64
10	805.24	1,764.56	11,103.08
11	768.25	1,901.55	9,201.53
12	520.63	2,049.17	7,152.36
13	461.54	2,208.25	4,944.11
14	280.11	2,378.68	2,564.43
15	105.37	2,564.43	[.00]

16,046.83 Total Interest

Table A2
Money Market Deposit Account

18,051.03 Beginning Principal
8.50 Interest Rate

Year	Interest	Principal
1	1,595.55	19,646.58
2	1,736.58	21,383.16
3	1,890.08	23,273.23
4	2,057.14	25,330.37
5	2,238.87	27,569.35
6	2,436.88	30,006.23
7	2,652.28	32,658.51
8	2,886.71	35,545.22
9	3,141.87	38,687.10
10	3,419.59	42,106.68
11	3,721.85	45,828.53
12	4,050.83	49,879.36
13	4,408.88	54,288.24
14	4,798.59	59,086.82
15	5,222.74	64,309.56

46,259.53 Total Interest

Table A3
NO CHANGE

Year	Interest from MMDA less Old Mortgage Interest at 7.5%
1	[173.82]
2	37.00
3	265.82
4	514.06
5	783.36
6	1,075.52
7	1,392.50
8	1,736.40
9	2,109.52
10	2,514.35
11	2,953.60
12	3,430.20
13	3,847.34
14	4,508.48
15	5,117.37
	30,211.60

ble A4
Fund for Investing Monthly Payments
ter Mortgage Payoff

222.48 Income to Fund per Month
8.50 Interest Rate

PAY OFF

Year	Paid to Fund	Interest	Principal
1	2,669.76	106.50	2,776.26
2	2,669.76	351.90	5,797.93
3	2,669.76	618.99	9,086.67
4	2,669.76	909.68	12,666.12
5	2,669.76	1,226.07	16,561.95
6	2,669.76	1,570.43	20,802.14
7	2,669.76	1,945.23	25,417.13
8	2,669.76	2,353.15	30,440.04
9	2,669.76	2,797.13	35,906.92
10	2,669.76	3,280.35	41,857.03
11	2,669.76	3,806.29	48,333.08
12	2,669.76	4,378.71	55,381.55
13	2,669.76	5,001.73	63,053.04
14	2,669.76	5,679.82	71,402.62
15	2,669.76	6,417.85	80,490.23

October 6, 1983

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means

The Honorable Robert Dole
Chairman
Senate Finance Committee

On behalf of the nation's housing and mortgage lending industries, we urge your committees to take action this year on legislation to remove the current tax impediments to portfolio restructuring programs.

H.R. 3357, as introduced by Representative Shannon, and S. 1147, as introduced by Senator Danforth, would defer the taxation of discounts offered by lenders to borrowers who prepay mature mortgages. A similar measure passed the Senate under the sponsorship of Senator DeConcini, but was dropped in the conference on H.R. 2973. We hope that your committees will take this opportunity to enact this legislation which, at no cost to the Treasury, (see attached study) will help lenders with large holdings of old mortgages restructure their portfolios and channel new funds into housing. An in-depth review of this issue is also attached.

This legislation, while not a panacea to the problems caused by portfolios of low interest, fixed-rate mortgages, will help the housing and mortgage lending industries and the nation's economic recovery efforts. We urge your positive action on this legislation as soon as possible.

cc: Members of Committee on Ways and Means
Members of Senate Finance Committee

Saul B. Klaman
President
National Association of
Mutual Savings Banks

Theresa L. Watson
President
American Savings and Loan
League, Incorporated

Roy G. Green
Executive Vice President
U.S. League of Savings
Institutions

William L. Reynolds
Executive Director
National Savings and Loan League

Dr. Mark J. Riedy
Executive Vice President
Mortgage Bankers

Gerald K. Lowrie
Executive Director,
Government Relations
American Bankers Association

Kenneth Guenther
Executive Director
Independent Bankers Association
of America

James C. Barr
Executive Vice President
Credit Union National Association

Robert D Bannister
Senior Staff Vice President
National Association of
Home Builders

Senator DANFORTH. Do I understand that all three of you generally support the legislation?

Mr. CUMBERLAND. Yes.

Mr. TUCCILLO. That is correct.

Senator DANFORTH. And Mr. Cumberland, are you the only one on this particular panel who takes the view about the inclusion of Fannie Mae and Freddie Mac, that they should be included?

Mr. TUCCILLO. No, Senator. The council also supports the inclusion of Fannie Mae and Freddie Mac in this legislation.

Senator DANFORTH. Mr. Levy.

Mr. LEVY. Our concern lies with one of the suggestions made here today by Treasury. It would appear that they would not premit Freddie Mac participation certificates or Fannie Mac mortgage-backed securities to be used to form the TIM's pool.

I would point out that savings and loans have swapped some $25 billion in mortgages as part of a restructuring procedure, and to shut off the access to TIM's for the disposal of these low-rate loans would, I think, be an undue hardship and would stand in the way of the restructuring process.

Senator DANFORTH. What would be the impact of TIM's on savings and loans and their desire to restructure their portfolios?

Mr. LEVY. Well, initially, as I pointed out, many savings and loans have swapped their mortgages with Freddie Mac for participation certificates. The hope would be that if TIM's came along, those participation certificates could be put into a TIM's to enhance the pricing on disposal of the certificates and make it possible for the institutions to dispose of these lower-rate instruments.

Senator DANFORTH. Gentlemen, thank you very much.

Mr. LEVY. Thank you, sir.

Mr. CUMBERLAND. Thank you, Senator.

Senator DANFORTH. The next panel: Mr. Ranieri, Mr. Fink, Mr. Pratt, and Mr. Maxwell.

Mr. Ranieri.

STATEMENT OF LEWIS S. RANIERI, MANAGING DIRECTOR, SALOMON BROTHERS, INC., NEW YORK, N.Y.

Mr. RANIERI. I thank the chairman for giving my firm the opportunity to comment on Senate bill 1822, which we strongly support.

I would like to make the point that the technology which this bill would enable us to employ in its most effective form has recently been introduced to the market, and has been demonstrated to save 50 to 75 basis points in the mortgage rate in the case of the Federal Home Loan Mortgage Corporation's CMO offering, and in the case of the three private sector offerings which have been done in the last 3 weeks. The rate savings was in excess of 50 basis points; so we are talking about a technology which, if employed through this bill, will by demonstration save 50 basis points to the homeowner.

I would caution the committee that, although the technology can currently be employed, it cannot be for any extended period of time. The potency in terms of rate savings to the mortgage market is greatly diluted because we have to do it in a debt format, there-

by encumbering somebody's balance sheet, for which they charge a premium.

Thank you.

Senator DANFORTH. Thank you, sir.

[Mr. Ranieri's prepared statement follows:]

STATEMENT OF LEWIS S. RANIERI, MANAGING DIRECTOR, SALOMON BROTHERS INC., BEFORE THE SENATE COMMITTEE ON FINANCE CONCERNING S. 1822, "TRUSTS FOR INVESTMENT IN MORTGAGES"

Mr. Chairman, members of the Committee on Finance, my name is Lewis S. Ranieri and I am a Managing Director of Salomon Brothers Inc. My principal responsibility at Salomon Brothers Inc is the direction of our firm's Mortgage Securities Department, which encompasses all our activities in the origination, sales and trading of mortgage related securities and mortgage loans. I appreciate this opportunity to testify before this distinguished Committee this morning with respect to Senate Bill 1822 - the TIM's Proposal.

I would like to begin my testimony with some general remarks regarding Salomon Brothers Inc's mortgage backed securities activities and the economic circumstances which have produced the need for this legislation. I would then like to comment on the specific benefits which will result from the enactment of Senate Bill 1822.

Salomon Brothers Inc has long been involved in developing innovative mechanisms to permit the residential mortgage lending industry to obtain access to the vast resources of the national capital market in order to satisfy the demand for housing finance. Our Firm was among the initial investment banking firms for mortgage backed securities ("MBS") offerings by the Government National Mortgage Association ("Ginnie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and, more recently, the Federal National Mortgage Association ("Fannie Mae"). In 1977, Salomon Brothers Inc, together with the Bank of America, developed the format for the first privately issued MBS. To date, private sector issuers have offered publicly in excess of $3 billion of MBS using this format, and Salomon Brothers Inc has been either the managing or co-managing underwriter of substantially all of these offerings. Earlier this year, Salomon Brothers Inc assisted Freddie Mac in the development of the structure for its Collateralized Mortgage Obligation ("CMO") offerings and has acted as managing or co-manging underwriter for each of the two issues it has subsequently sold, aggregating approximately $1.7 billion. Since the announcement of Freddie Mac's initial CMO issue, several private sector issuers have filed registration statements with the Securities and Exchange Commision for similar issues based on Ginnie Mae securities, and Salomon Brothers Inc has been named managing or co-managing underwriter for approximately half of these prospective financings.

In addition to our activities in the design and structuring of MBS and in the management of MBS offerings, Salomon Brothers Inc maintains a significant commitment to making an active and liquid secondary market in MBS. At any one time, a large portion of the capital of our parent, Phibro-Salomon Inc, is available to support of our MBS trading activities. On a regular basis we maintain trading markets in the securities of Ginnie Mae, Fannie Mae and Freddie Mac as well as in MBS which have been offered publicly or sold privately by private sector issuers. During an average month,

our volume of MBS transactions ranges between $12-$15 billion and has been significantly in excess of these amounts on several occasions.

Despite this level of activity at our Firm and comparable efforts being made by several of our Wall Street competitors, however, the capital market is presently a relatively inefficient means to finance residential housing. Although the techniques of mortgage securitizing - the act of pooling mortgages and issuing a security backed by these mortgages - has been practiced since the inception of Ginne Mae in 1970, over the last thirteen years only approximately $250 billion of residential mortgage loans have been funded by MBS sold in the public market. While this amount may seem large, I would like to point out that during this period total residential mortgage originations have aggregated approximately $1.4 trillion, indicating that MBS have provided less than 20% of the needed housing finance. In addition, more than $170 billion - or 2/3's - of all the MBS which have been sold publicly have been Ginne Mae's backed by FHA/VA loans, which are full faith and credit obligations of the U.S.Government. Since conventional - or non-federally insured mortgages - have accounted for, on average, 80% of annual mortgage originations over these years, FHA/VA loans have thus been securitized and sold as MBS at a rate more than three times greater than their market share. Freddie Mac, which is the largest single issuer of MBS backed by conventional mortgage loans and has been active in the market place since 1971, presently has only $51.5 billion of conventional MBS outstanding, most of which were issued since the implementation of its "mortgage swap" program in late 1981. Fannie Mae, which began issuing conventional MBS only in 1980, now has approximately $21.5 billion outstanding, a substantial portion of which was also issued in "mortgage swap" transactions. Private sector issuers have sold publicly only about $3 billion of conventional MBS, giving us a grand total for publicly issued conventional MBS of roughly $76 billion, with only a small additional balance of conventional MBS being attributable to non-public financings.

In relation to the total demand for mortgage credit, it is clear that the aggregate amount of financing which has been provided by sales of all types of MBS over the last thirteen years has been woefully small. Even more appalling has been the nearly insignificant level of conventional MBS issuance and, in particular, the almost total lack of participation by private sector issuers in the creation and sale of MBS. While the lack of private sector involvement can be largely attributed to the statutory and regulatory impediments which are addressed by Senate Bill 1822 and its companion, Senate Bill 1821, it is apparent that this lack of involvement cannot be permitted to persist if the future demand for housing credit is going to be satisfied.

Salomon Brothers strongly supports legislative action to remove the statutory and regulatory impediments which have prevented privately issued conventional MBS from becoming an efficient means of financing residential housing. If enacted, we believe Senate Bill 1822 will provide an environment conducive to the expansion of the issuance of MBS by private sector entities to provide the necessary funds to finance the dream of home ownership for this generation of Americans and generations to come. We also believe Senate Bill 1882 will greatly enhance the liquidity of savings and loan associations, the traditional originators of mortgage loans, will more efficiently distribute available residential mortgage credit, and will increase significantly the number and types of institutions which may invest in MBS.

As all of you know, the housing industry has experienced a startling recovery over the last eighteen months. Reflecting this recovery, one-to four-family mortgage originations in the first six months of 1983 have soared to an estimated $84 billion, more than double the amount for the same period of 1982. If mortgage originations continue at this pace, the total mortgage credit need for 1983 could exceed $170 billion. Although this amount approaches a "record", many housing analysts suggest that over the next ten years up to $4 trillion dollars will be needed to finance housing. Such an amount of financing can only be provided by the capital markets which can only be tapped through a mechanism which allows private issuers to securitize mortgages and efficiently sell the resulting MBS. Further, as the thrift industry, which historically has been responsible for about 50% of total mortgage originations, no longer appears able to fund housing to the same extent, private sector involvement in the securitization of conventional mortgages must be encouraged through legislation such as Senate Bill 1822 if the future's enormous demand for mortgage credit is to be satisfied.

MBS are needed to provide the capital and liquidity necessary to support the demand for housing finance and to enable a diversified investor base to share the market risk of long-term fixed rate mortgage loans. A new opportunity for MBS will be introduced as we continue to target specific investors with specific issues. Presently, we can create mortgage securities that provide thrifts with the short maturities they need to match against their short-term liabilities; life insurance companies with the medium-term maturities they desire; and pension funds with the long and stable maturities they require. Senate Bill 1822 will greatly facilitate the creation of MBS by the private sector and will make the task of designing issues to reach each of these investor categories, as well as others, much easier. As a result, Senate Bill 1822, if

enacted, will significantly enhance the ability of private MBS to complete for funds with traditional corporate debt issues in the capital market and will open up important new sources of mortgage credit to the benefit of the homebuyer.

Advantage of the TIM's Proposal

In our opinion, the TIM's Proposal will provide mortgage originators with valuable additional structural flexibility in the creation of mortgage pools and in the design of related issues of conventional MBS. This additional flexibility should, in turn, permit the achivement of higher prices (lower interest costs) for MBS, which will result in lower mortgage rates for the homebuyer. The TIM's Proposal should also broaden the market appeal of MBS and should encourage the development of a broader and more liquid secondary market for these securities. Both of these results should serve to further enchance the benefits which will acrue to the homebuyer from this legislation.

Structural Advantages

The TIM's Proposal will offer mortgage originations four important areas of additional structural flexibility in the design and sale of conventional MBS.

First, through the provisions which would permit a TIM to invest its funds in alternative securities ("Permitted Investments") or other mortgage instruments ("Qualified Short-Term Mortgage Investments") for a period of up to 18 months prior to their commitment to mortgage loans ("Qualified Obligations"), mortgage lenders will be able to offer MBS representing to-be-originated mortgage loans for immediate delivery in the public market. Such offerings would be particularly attractive to investors which require immediate employment of their funds and to issuers, especially mortgage bankers and homebuilders, which need to obtain long-term, fixed cost, future financing commitments on a regular basis to support their ongoing mortgage lending programs.

At the present time, less than half of the investors which purchase MBS will purchase issues representing to-be-originated mortgage loans for future delivery, due in part to the credit risks associated with such transactions. In addition, for similar reasons, the longest period for which MBS can be sold for future delivery is currently three to six months. By enabling immediate delivery of MBS representing to-be-originated mortgage loans, the TIM's Proposal will eliminate the associated credit risks and will thereby effectively achieve a doubling of the potential size of the market for MBS. Further, by permitting the period prior to which funds must be committed

to mortgage loans to run as long as 18 months, the TIM's Proposal will markedly increase mortgage lenders' ability to utilize MBS in the capital market to fund their future mortgage lending activities. Together, the combined impact of these two aspects of the TIM's Proposal will have a significant stabilizing effect on the prices and yields of MBS in the capital market.

It is important to note that mortgage lenders other than mortgage bankers and home builders, particularly commercial banks and thrift institutions, could find the ability to sell MBS for extended future delivery an attractive alternative source of financing for their mortgage lending activities as compared to deposits and other types of liabilities. As financial institutions' liabilities become shorter in term and more sensitive to market interest rates, the ability to access long-term, fixed cost funds raised through a forward delivery mechanism may be the only means to maintain these lenders in the mortgage market.

Second, through the provisions which would give a TIM the ability to manage the cash flow received from principal prepayments on Qualified Obligations, mortgage originators will be able to create mortgage pools and related MBS which have predictable cash flows. At the present time, one of the major impediments to the marketing of mortgage-backed securities to conventional fixed income investors has been the inability to offer complete call protection as well as assurances as to the specific average life or absolute final maturity of these investments. If these technical impediments are able to be reduced or eliminated through the reinvestment of a TIM's cash flow from non-scheduled prepayments in new Qualified Obligations or other Permitted Investments, then the related securities will be able to be marketed to a broader universe of investors and on more competitive terms as compared to conventional debt instruments. Understandably, investors in fixed income securities place a high degree of importance on the predictability of the cash flows produced by their investments.

Third, through the provisions which would permit a TIM to sell up to all of its Qualified Obligations after an initial three-year holding period, a TIM will be able to "manage" the "maturity" of its MBS. This ability to create a predictable final maturity for its MBS through a sale of the underlying assets, together with the ability to control the distribution of the interim cash flows through a reinvestment mechanism as described above, will enable a TIM to tailor individual issues to appeal to specific maturity segments of the capital market. As a result, a TIM will be able to respond to shorter-term changes in capital market preferences as to maturity while continuing to offer mortgage instruments with reasonably constant terms to borrowers. As the intermediate-term maturity segment

of the capital market has consistently been both large and active, a TIM's ability to create MBS with an intermediate term maturity from longer term mortgage loans will importantly enhance the ability of the mortgage market to access capital market funds.

The ability of a TIM to create MBS with a predictable final maturity will result in the elimination of the significant price and yield disadvantages which mortgage-backed securities have suffered in the capital market. As an indication of the potential impact of this ability, a TIM with a predictable final maturity and controlled interim cash flows should be able to eliminate most, if not all, of the adverse spread of approximately 125 basis points which presently persists between MBS (conventional mortgage pass-through certificates, GNMA's, FHLMC participation certificates and FNMA conventional mortgage backed securities) and their corporate, Treasury and Agency counterparts.

Fourth, through the provisions which would permit a TIM to have up to three separate classes of shares, a TIM will be able to offer single issues of MBS which simultaneously appeal to each of the major maturity segments of the capital market - short, intermediate and long. Using its authority to invest non-scheduled prepayments on Qualified Obligations and to sell various amounts of its Qualified Obligations in various years in order to redeem its own securities, a TIM will be able to create a single MBS, portions of which can be sold to short term (up to 5 years), intermediate term (7 to 15 years) and long term (15 years and over) investors. This flexibility to structure a private MBS in this manner will greatly assist a TIM in the achievement of competitive interest costs in the sale of its securities in the capital market.

Significantly, a very substantial number of mortgage originators, including thrift institutions, commercial banks and mortgage bankers, have the capacity to issue MBS under the TIM's Proposal in an annual volume in excess of $100-200 million. In the first year of the existence of the TIM's Proposal, however, it is likely that only the more aggressive of these prospective issuers would elect to participate. In later years, the degree of participation by mortgage originators generally will depend upon the degree of success or failure achieved by these initial pioneers. Assuming reasonably receptive market conditions, we would anticipate that the initial year's volume of TIM Proposal MBS issues would be between $2-3 billion, and that the volume in the first five years would be between $20-25 billion. Substantially all of such volume would represent new money for housing from the capital markets.

MTG-102/9

31-489 O—84——12

Pricing Advantages

The ability of a TIM to structure its issues to eliminate the cash flow uncertainties presently associated with MBS should result in the achievement of higher prices (lower interest costs) for its issues. At the present time, all MBS, including GNMA certificates, trade at a discount to their corporate, Agency or Treasury counterparts. In general, these discounts can be attributed largely to investors' uncertainty with respect to the cash flows resulting from these investments and relatively little to their concerns as to credit quality.

As we have indicated previously, we would expect that a TIM issue which incorporated provisions for the reinvestment of interim cash flows and for the early retirement of portions of the security, thereby providing well defined cash flows and a fixed maturity schedule to the capital market, could be priced considerably more aggressively than the present form of long-term MBS. However, it can reasonably be expected that it will be some time after the TIM's Proposal becomes effective until investors (including in particular those investors which will be enabled to purchase MBS for the first time as a result of the Senate Bill 1821) gain sufficient experience to become willing to bid as aggressively for MBS as for equivalent quality corporates.

To the extent that mortgage originators can achieve a lower cost of financing from the use of a TIM and to the extent that mortgage originators compete in the origination of mortgage loans, market forces should result in this cost savings being passed on directly to the homebuyer. If the financing costs savings or a TIM are passed on to the homebuyer, the cost of housing finance will be reduced. Whether a reduction in the cost of housing finance will stimulate increased demand for housing will depend upon relative cost levels prevailing in the economy generally. The TIM's Proposal's advantages will only be able to divert a significant volume of credit from the corporate and government securities markets if mortgage originators are willing to compete for funds in the capital market by paying the necessary interest costs. Such competition, if begun, will continue only to the point where mortgages can no longer be originated in sufficient volume to support new TIM issues bearing higher yields.

Market Appeal

To the extent that the lack of predictability of MBS's cash flows, average lives and maturities can be overcome through the use of the structural flexibility offered by the TIM's Proposal, such issues can be expected to enjoy much broader investor interest.

Additionally, if TIM issues enjoy more equitable treatment under the various states' legal investment statutes and ERISA as compared to present issues of MBS, the universe of prospective investors will increase dramatically. We would expect that TIM issues could be structured to appeal to all of the major classes of investors in the capital market, including insurance companies, pension funds (both public and private), commercial banks, thrift institutions and, under certain circumstances, individual investors.

To date, one of the major impediments to the successful sale of MBS to taxable investors, including individual investors, has been the negative bias against such issues under the Internal Revenue Code. Currently, the accretion of discount on MBS is taxed as ordinary income while amortization of premium is taxed as a capital loss. The tax treatment of these same items of income on corporate bonds is exactly the reverse, with accretion of discount being taxed as a capital gain and amortization of premium treated as ordinary loss. It would therefore be desirable for the TIM's Proposal to equalize the tax treatment of accretion of discount and amortization of premium on MBS and corporate bonds. With equal tax treatment, MBS should appeal to a broad array of taxable investors which have not been major participants in the mortgage securities market in the past.

In addition, it would be desirable for the TIM's Proposal to provide that TIM securities are qualifying assets for tax purposes for savings and loan associations and real estate investment trusts so that their purchase by these entities will be encouraged.

Secondary Market Trading

To date, only a limited number of securities dealers have maintained active secondary markets in MBS. This lack of widespread dealer participation can be attributed to the same factors which have discouraged broad investor interest in these issues - uncertainty as to cash flow, average life and maturity - as well as to the technical difficulties associated with MBS settlement, to the capital requirements of MBS trading and, finally, to the lack of broad investor interest. When each of these elements of "risk" is removed by one or more provisions of Senate Bill 1821 and the TIM's Proposal, and in particular as the base of eligible investors expands in number and in its financial commitment to the mortgage market, a greater number of dealers, both large and small, will commence and maintain active secondary market trading operations in MBS.

Summary and Comment on Role of Fannie Mae and Freddie Mac

The TIM's Proposal is a well-conceived legislative proposal that will greatly enhance the ability of the mortgage market to access the capital market to obtain resources in support of the ongoing demand for housing credit. The TIM's Proposal will also revolutionize the market for MBS and, in particular, the manner in which such securities are able to be utilized by their issuers.

As the advantages of the TIM's Proposal could outweigh the value of their Agency credit standing and thus imperil their ability to compete, we believe that the TIM's Proposal must be applicable to all issuers of mortgage-backed securities, including Fannie Mae and Freddie Mac.

STATEMENT OF WILLIAM P. McCAULEY, VICE PRESIDENT, DEPUTY MANAGER, MORTGAGE PRODUCTS GROUP, FIRST BOSTON CORP., NEW YORK, N.Y.

Mr. MCCAULEY. Mr. Chairman, my name is Bill McCauley. I am the deputy manager of the Mortgage Products Group at First Boston. Our manager, Larry Fink, regrets he couldn't be here today.

Senator DANFORTH. Oh, all right. Thank you.

Mr. MCCAULEY. We at First Boston have been a proponent of the TIM's concept since its inception with the President's Commission on Housing. But rather than talk about the specifics of this bill today, I thought it would be useful to explain one particular use of TIM's that demonstrates its merits in today's environment.

There is a standoff in today's mortgage market. Today's consumer still wants a 30-year fixed rate mortgage, while mortgage portfolio lenders have a growing reluctance to give them. If we had enactment of the TIM's legislation, S&L's and banks would be better able to meet this mortgage demand. Here is how I see it working:

The S&L's would continue to make 30-year mortgages in amounts that they are comfortable with, and pooling them into this so-called fast-pay, slow-pay security that you heard about before. The S&L's would then sell the longer or slow-pay portion to pension funds and retain the short-term portion for their own portfolios. The results are simple:

First, the existing mortgage distribution network would be upgraded by TIM's and better utilized;

Second, the consumer would continue to get 30-year fixed rate mortgages and at lower rates, as I explained in my written testimony and as Mr. Ranieri just alluded to;

Third, the S&L would book a short-term mortgage asset, something that he has difficulty attaining right now;

And fourth, the pension fund buyer would get a mortgage instrument with call protection.

Two major changes to S. 1821 as currently drafted, that First Boston would recommend:

First, TIM's securities should be treated as qualifying real property loans for S&L's, and

Second, TIM's securities holders should receive capital gains treatment on recovery of market discounts as they do corporate bonds.

We at First Boston think the concept works. We think it is needed. And we would be happy to provide the committee with our analysis of the more technical provisions of the bill.

Senator DANFORTH. All right. Thank you, sir.

[Mr. McCauley's prepared statement follows:]

STATEMENT

ON

THE TRUSTS FOR INVESTMENTS IN MORTGAGES ACT

OF 1983

BEFORE

THE SENATE FINANCE COMMITTEE

OF

THE FIRST BOSTON CORPORATION

BY

WILLIAM P. McCAULEY

November 4, 1983

Introduction

My name is Bill McCauley and I am a Vice President of The First Boston Corporation and Deputy Manager of our Mortgage Products Group. First Boston is a leading international investment bank and our Mortgage Products Group is one of the finest on Wall Street. The Mortgage Products Group is specifically charged with serving the investment banking needs of the thrift industry, and more broadly, the mortgage financing needs of the nation. This includes such activities as trading and sales, underwriting, stock conversions, financial advisory services and dealing in all mortgage related securities and whole loans, of both the private and public sectors. It is from this perspective that I address you today, and I thank you for the opportunity to do so.

The express purpose of S. 1822 is to amend the Internal Revenue Code of 1954 to encourage investments in mortgages through a new flow-through type of entity, Trusts for Investments in Mortgages, or TIMs. More broadly, the TIMs initiative is an attempt to add flexibility to existing mortgage security structures and to facilitate the flow of mortgage credit in the private sector. First Boston believes that this initiative is sorely needed by many mortgage market participants, particularly in the wake of recent financial institutions deregulation. Furthermore, to the extent mortgage credit is more efficiently delivered as a result of TIMs the future home buyer of America will ultimately benefit. First Boston strongly supports this initiative.

Background

In order to understand the potential and the impact of a TIM it is useful to draw a comparison between it and the standard mortgage security, the pass-through. Pass-through securities, with close to $300 billion outstanding, represent the most common form of mortgage security and account for more than 95% of the total. However, their structure is rigid. Generally, existing tax regulations require that the security characteristics very closely resemble those of the pool of mortgages underlying the security. Therefore, the pass-through is nothing more than a convenient bundling of mortgages, the cash flow from which is passed through to investors by the issuer on a monthly basis terminating when the initial pool of mortgages has been paid off.

There are three inherent problems with this type of structure. First, investors are unable to accurately predict the duration of their investment since all cash flow (including prepayments) is required to be passed through to them as received. This uncertainty is of particular concern to pension fund investors which must match these cash flows with the future funding requirements of their pension plans. Second, pass-through investors normally receive monthly cash flows, as compared to the more traditional semi-annual payment schedule of most other bonds. Third, active management of mortgage pool cash flows is forbidden. This restriction, perhaps the most onerous, inhibits issuers from designing different classes of securities to meet the needs of specific investor sectors.

The most significant factor currently requiring standardization (and responsible for the above shortcomings) of pass-throughs is the grantor trust. In order for a pass-through security to avoid taxation at the pool level, and pass-through tax liability to the security holders, it must qualify as a grantor trust. To do so, the security structure must comply with regulations and rulings issued by the Treasury Department, and applicable case law on this subject. Although there are a number of outstanding rulings, both public and private, to provide guidance, the approved structures are, nevertheless, generally restrained in the manner described above. Consequently, most pass-throughs are similar in structure.

However, both the issuer and the investor side of the mortgage market are increasingly demanding more flexibility in the types of mortgage securities which they buy and sell. The TIMs initiative would help to alleviate the inadequacies of pass-through securities mentioned above, and most probably would result in a lower cost of mortgage money to homebuyers.

Discussion

The most likely form of TIMs to be created by mortgage market participants is the fast-pay/slow-pay security. This type of security structure may have two or more classes of bonds backed by one pool of mortgages. Such securities require that cash flows, once received at the pool level, be separated and designated for specific classes of bonds. The first class of this security is designated fast-pay, the other slow-pay. Investors holding the

fast-pay class receive all principal payments (including prepayments) and interest thereon, until they have received the entire principal represented by their class of security. The fast-pay class appeals to investors seeking short-term assets, such as S&Ls, while the slow-pay portion appeals to pension fund investors.

A variation of this type of security was first issued on June 6, 1983 by Freddie Mac, and since then there have been about seven other such issues. Although the apparent structure of these securities resembles that of the fast-pay/slow-pay security explained above, there is one major difference. That is, each of these securities was issued as a debt instrument rather than a sale of assets instrument. This security structure, known as Collateralized Mortgage Obligation (CMO), would not qualify as a grantor trust and, therefore, a sale of assets by the issuer under this arrangement could not be achieved. The implications of this are important. First, issuance of such securities is not feasible for most mortgage originators since they are not able to "gross-up" their balance sheets and still maintain adequate capital ratios. Furthermore, these securities are not considered "qualifing real property loans" or "real estate assets" to investors which are thrift institutions and real estate investment trusts, respectively. This fact considerably lessens the attractiveness of such issues for such investors.

The TIMs initiative should alleviate both of these shortcomings and allow most mortgage originators to take advantage of a financing vehicle that has already proven its effectiveness, but

has been limited to a few special types of issuers. How has this vehicle proven its effectiveness?

Exhibit I is a graphic display of the spread between current coupon GNMAs and 10 year Treasury issues. GNMAs were selected as a proxy for mortgage rates since six of the eight CMO issues to date have been backed by GNMAs. As you can see on July 22, the date of the first such issue, the yield of GNMAs was 133 basis points higher than that of the comparable Treasury. However, as of October 31 that same spread had narrowed to 85 basis points. Amplifying this dramatic spread change is the fact that during this time period the absolute level of Treasuries rose. Normally, under these circumstances one would expect a spread such as this to actually widen in concert with the rising rates. However, the opposite happened.

There are two possible explanations - either the supply of GNMAs has diminished or the demand for them has increased. While it is true that GNMA issuance has dropped during this time period, we believe that perhaps half of the spread compression can be attributed to increased demand for GNMAs in the form of CMOs. This demand has come from all sectors of the investment community, as well as many non-traditional mortgage investors. Since each class of CMO security was attractive to a different type of buyer, the aggregate demand for the entire issue was increased. An approximation of this value added is 24 basis points, half of the 48 basis point spread decrease which occured during the observation period. If this 24 basis point relative savings is passed along to the homeowner, then the efficiency of the structure is proven.

Although it is difficult to trace such a number all the way back to the mortgagor, the FHA rate was dropped on October 30 from 13% to 12 1/2% in spite of the fact that Treasury rates had been trending upward.

First Boston believes in the economic value of this new security structure and would like to see more widespread use of it. We believe that TIMs is a structure that could have a far reaching impact on mortgagees, as well as the mortgagors. For example, the typical borrower from an S&L still wants a 30 year, fixed rate mortgage; yet interest rate deregulation has shortened the average maturity of the S&L's liabilities and exacerbated its asset-liability mismatch. If it were to become a TIMs issuer, it could continue to make 30 year mortgages, satisfying its natural consumer demand; yet, by selling off the slow-pay portions of its TIMs security, (a "sale of assets" for accounting purposes), and retaining the fast-pay portions for its own account, the S&L could book only short term assets, and avoid the increased risks associated with 30 year mortgages. These risks are better managed by pension fund investors, the likely takers of slow-pay TIMs.

This type of usage by mortgage lenders will help to preserve the existing mortgage delivery system, while at the same time, allow the private sector of the mortgage market to undertake the development necessary to assure the continuous flow of mortgage credit in a new and rapidly changing environment.

Due to the relative infancy of the private mortgage backed securities market, we at First Boston believe it is necessary to rely on the existing market framework during the developmental

phases of the private sector. Specifically, we feel that the proposed bill should be amended to give both FNMA and FHLMC the ability to issue TIMs. With this power they will continue to provide the leadership necessary for the private sector to follow. Without it, the TIMs securities described above will probably only be issued by the largest mortgage originators. The many smaller issuers would be closed out of the marketplace, since investors in these new securities will demand the liquidity, fungibility and credit backing that only the larger issues could provide.

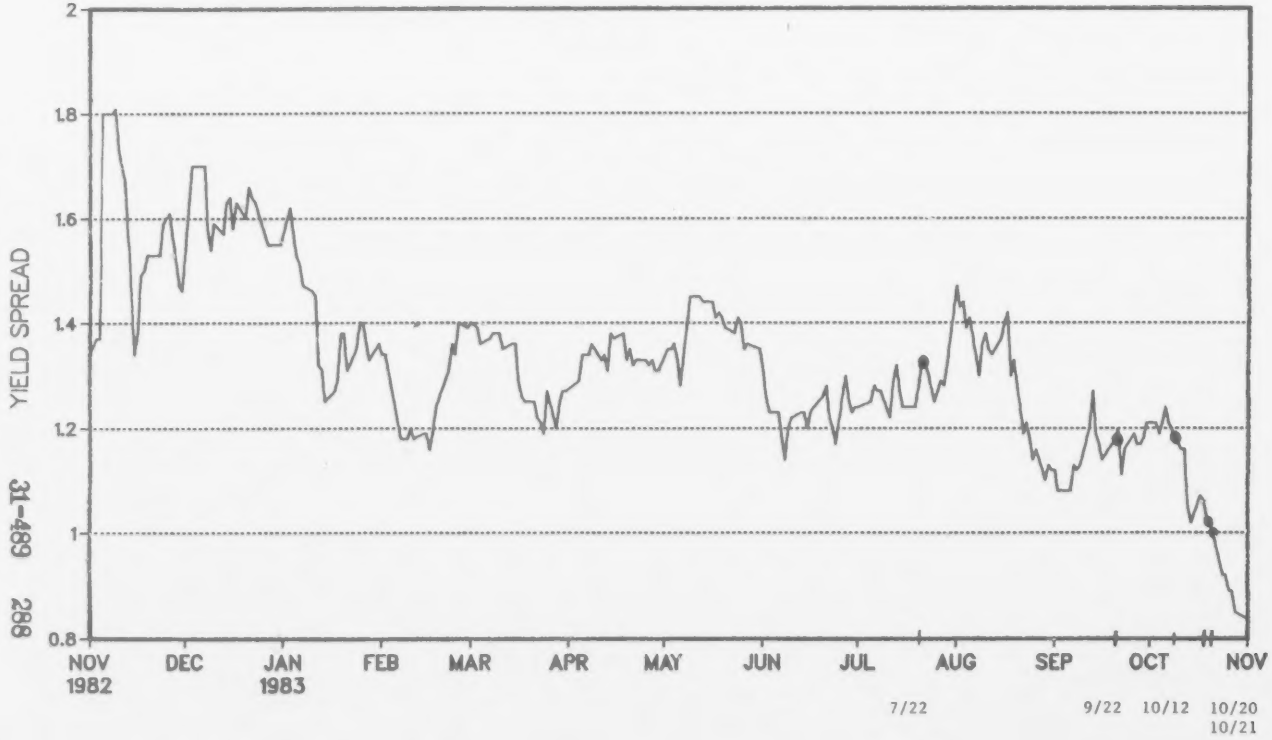
Conclusion

In summary, we at First Boston welcome and applaud the TIMs initiative. S. 1822 and its companion S. 1821 are the first comprehensive attempts to modernize the tax and legal environment in which mortgage market participants operate. The industry, as evidenced by the many recent innovations, is reaching out for help. If the broad policy aims of TIMs are met, the mortgage distribution network in America will be given the necessary freedom to grow in accordance with the needs of this rapidly changing industry. Without this legislative initiative, the system will continue to deliver mortgage credit, but in a suboptimal manner, and at greater expense to future home buyers.

Mr. Chairman, my comments today were of a broad nature, and yet this bill contains many highly technical provisions. First Boston has analyzed these provisions and would be happy to provide you and your staff with specific comments and recommendations.

EXHIBIT I

YIELD SPREAD: CURRENT CPN GNMA–CURRENT CPN 10 YEAR TSY
11/ 1/82 TO 10/31/83



THE FIRST BOSTON CORPORATION
FIXED INCOME RESEARCH

EXHIBIT II

The accompanying graph charts the yield spreads between the current coupon GNMA and current 10-year Treasury from October 31, 1982 to October 31, 1983. The yield spread on the day following the respective CMO offerings is specifically shown on the graph.

July 22, 1983	Guaranteed Mortgage Corporation Series A
September 22, 1283	Investors GNMA Mortgage-Backed Securities Trust, Inc. Series 1983-1
October 12, 1983	Guaranteed Mortgage Corporation Series B
October 20, 1983	Ryan Mortgage Acceptance Corporation II Series I
October 20, 1983	American Southwest Financial Corporation Series C
October 21, 1983	Centex Acceptance Corporation Series B

STATEMENT OF RICHARD T. PRATT, PRESIDENT, MERRILL LYNCH MORTGAGE CAPITAL, INC., NEW YORK, N.Y.

Senator DANFORTH. Mr. Pratt.

Mr. PRATT. Thank you.

I represent Merrill Lynch, a major marketmaker in mortgage-backed securities. Along with other major New York houses, we are currently involved in the issuance of several hundred million dollars of mortgage-backed securities of the type that may become more popular and more versatile under the TIM's situation.

I would first like to point out the immense size of this market and the importance to the American public. In the first 6 months of this year there were over $93 billion of one-to-four family mortgages originated in this country. There is $1.3 trillion of these mortgages on one-to-four family units held at this time.

In terms of the evolution of the mortgage instrument, in 1970, 1.1 percent were held as mortgage-backed securities; in 1983 that has risen to 23.1 percent. For mortgages coming into the capital markets, this benefits the American public. This bill goes a long way to provide a more flexible, more efficient access of mortgages to the capital market. It will benefit the American people; it will make housing finance more available, at lower cost.

We have comments on the bill, but our emphasis is on the importance of this to the mortgage markets and to the people of America.

Senator DANFORTH. Thank you very much.

[Mr. Pratt's prepared statement follows:]

STATEMENT OF RICHARD T. PRATT, PRESIDENT,
MERRILL LYNCH MORTGAGE CAPITAL, INC.,
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

My name is Richard Pratt. As President of Merrill Lynch Mortgage Capital, Inc., I am pleased to appear before this subcommittee to testify on S. 1822, the Trusts for Investment in Mortgages Act.

I would like to direct my comments to two aspects of the proposed legislation. First, I will address the general purpose of the Trust for Investment in Mortgages ("TIMs") concept, its relationship to an active, private, secondary mortgage market, and its relationship to the companion legislation, S. 1821, the Secondary Mortgage Market Enhancement Act. Then, I will address the specific tax legislation for TIMs, S. 1822, which is before this Committee.

Merrill Lynch Mortgage Capital, Inc. is a newly founded subsidiary of Merrill Lynch Capital Markets, the global investment banking arm of Merrill Lynch & Co. As the company name implies, Merrill Lynch Mortgage Capital, Inc. was organized to further Merrill Lynch's activities in bringing to fruition what we believe is the growing union of the nation's capital markets and its mortgage credit markets.

As a leader in investment banking with a large retail and institutional clientele, Merrill Lynch has been at the forefront

31-489 O—84——13

of many of the recent changes in mortgage credit markets. Through Merrill Lynch Realty, Inc., Merrill Lynch is now actively engaged in the marketing and financing of residential real estate. We see great potential for both Merrill Lynch and our clients in the marketplace to finance home mortgages by tapping the capital markets through the issuance, underwriting, or sponsorship of mortgage-backed securities or, in other words, TIMs.

As this Committee is well aware, for many years the home mortgage credit market occupied a distinct niche in the nation's credit markets partially divorced from the mainstream credit and capital markets. As a result of a changing economic environment, the sources of funds for the traditional suppliers of mortgage credit are now more costly and more volatile. In the face of this increased economic and financial risk, traditional lenders are relying more heavily on the sale of home mortgages into the secondary market, and many portfolio lenders have come to look more like mortgage bankers who originate and service mortgages. Indeed, the Mortgage Bankers Association of America estimates that nearly sixty percent (60%) of the mortgage loans originated in 1982 were sold into the secondary market. This compares to an average of only 30% during the decade of the 1970's. This is, of course, a result of the economic difficulty experienced by traditional portfolio lenders such as thrifts. Industry sources predict that by 1990, or perhaps earlier, seventy-five percent of all mortgages originated will be sold into the secondary

market. In sum, the mortgage credit market is becoming increasingly indistinguishable from the nation's capital market.

The secondary market, of course, has traditionally been and is now dominated by three Government-backed entities -- the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC"). Their dominance of the secondary mortgage market is, in some measure, an indiction of their success in carrying out their designated public functions in the formation of a secondary market and as major suppliers of mortgage credit. Although the absence of private participants in the secondary mortgage market may not necessarily be a result of these government agency successes, there is no doubt that provisions of existing tax, securities, and other laws have hampered the development of an active, private secondary mortgage market.

We reiterate here what we stated before the Subcommittee on Housing and Urban Affairs of the Senate Banking Committee at its hearings on the Secondary Mortgage Market Enhancement Act. The bills introduced by Senators Garn and Tower, by proposing to remove those unintended impediments, are an essential first step in the development of a private secondary mortgage market. As such, we applaud the concept and intent of S. 1821 and S. 1822.

The TIMs legislation -- both S. 1821 and S. 1822 -- properly recognizes that, because the nation's mortgage credit markets were for so many years separate from its capital markets,

securities, banking, tax, and other laws -- drafted and enacted without the notion of mortgage-backed securities in mind -- have inadvertently created barriers to the efficient union of those markets.

Some criticism has been levied against this union of the capital and mortgage markets on the grounds that mortgage credit needs will "crowd out" and raise the cost of corporate debt. First, although this argument may have some limited technical merit, to the extent there is any crowding out of corporate debt, it is largely a result of overall interest rate levels and not the tapping of capital markets through mortgage-backed securities. Moreover, any such limited crowding out cannot outweigh the need to recognize that traditional sources of home financing have weakened or disappeared and the need to develop new sources to finance housing, or the American ideal of home ownership will be only a dream for millions of Americans.

We believe, therefore, that the goals of this legislation are laudable and that our community of interest lies in assuring that the proposed legislation accomplishes these goals by (1) reducing the unintended impediments denying mortgage-backed securities full and equal access to the nation's capital markets; (2) placing mortgage-backed securities on an equal footing with other, comparable investment-grade securities; and (3) by so doing, allowing these instruments to be used flexibly and innovatively to meet the requirements of a wide variety of investors. We believe that the result of such a framework will be the development by private industry of an efficient mortgage capital

market. The ultimate beneficiary of these reforms, of course, will be the nation's home buyers who will enjoy the benefits of a more competitive and flexible marketplace.

With these comments in mind, I should like now to address with some specificity the bill before this Committee -- S. 1822 -- the Trust for Investment in Mortgages Act.

On September 22, I was privileged to appear before the Subcommittee on Housing and Urban Affairs of the Senate Banking Committee to testify in support of S. 1821, the Secondary Mortgage Market Enhancement Act. In testifying this morning on the companion tax bill, S. 1822, the Trusts for Investment in Mortgages Act, again I speak generally in strong support. But, while approbation is the dominant note, important aspects of the legislative proposal seem to us seriously defective.

In his remarks introducing S. 1822, Senator Tower rightly noted that present tax provisions, in particular the "grantor trust" rules, are inappropriately inflexible in their application to pooled mortgage investments. Current law unnecessarily constrains the ability of mortgage-backed securities to compete in the capital markets by imposing an insupportable burden of double taxation if the pool trustee is authorized to reinvest mortgage prepayments or otherwise actively to manage cash flows of the pool.

In order to avoid a double tax burden, historically mortgage-backed securities have been pooled through passive grantor trusts designed to satisfy restrictive "pass-thru" requirements. The

disadvantages inherent in these grantor trust vehicles have been noted at length: The investor has no protection against prepayment of the mortgages in the pool; the term of repayment becomes undependable; the investor is thus uncertain as to what he is buying. To counter that uncertainty or lack of "call" protection, the investor demands a premium which, ultimately, increases the mortgage costs borne by homeowners. Separately, under the current taxing regime, a grantor trust issuing certificates backed by a mortgage pool cannot issue different classes of trust interests -- the so-called "fast pay" and "slow pay" classes -- tailored to the requirements of different kinds of investors.

S. 1822, we believe, reacts sensibly to these concerns; and, in concept, we applaud it. The bill is designed to remove unnecessary impediments, promote flexibility, and allow the marketplace to operate. As drafted, however, S. 1822 leaves some questions unanswered and responds inappropriately to a few others. I will address the more important of these in the context of the bill's major themes.

Foremost among these is the decision to adopt a true pass-thru regime. S. 1822, properly we think, avoids the REIT formula of taxable entity and dividends paid deduction and provides, instead, that a TIM will be exempt from income tax while its shareholders, in the aggregate, annually will account for all of the income, gains, and deductions generated by the TIMs permissible investments. This underpinning concept, focusing the incidence of taxation exclusively at the investor level, is exemplary.

While the concept is exemplary, the mechanics of implementation embraced by the bill, the partnership tax provisions, are not. Resort to these complex rules, implicating a series of mandatory and elective adjustments, is unnecessary and can and ought to be avoided through the adoption of a more fully articulated, tailored, pass-thru statutory scheme.

In permitting a TIM to issue either a single class of stock or, subject to certain restrictions, multiple classes -- for example, a fast pay security and one or more classes of slow pay securities -- S. 1822 allows the mortgage pool to attract investors having quite different investment objectives. The legislation restricts the amount of indebtedness a multi-stock class TIM may carry. Undesirably, the restriction will limit investment flexibility. Presumably the restriction is imposed as a means of avoiding the unduly complicating tax rules that excess leverage might otherwise attract. Avoiding burdensome complexity is a worthy goal, but we would hope the Committee will undertake further study to determine whether that goal can be achieved in a more neutral way.

Collection gain attributable to market discount on corporate indebtedness is capital gain. Original issue discount on corporate indebtedness generates ordinary income which the investor must report over the life of the bond under a constant interest rate formula. Neither of these rules applies to a home mortgage. Collection gain on an obligation issued by an individual is ordinary income, but the investor reports that income only as principal payments are received. Obviously, these general tax rules

are discordant. The legislation might have attempted to harmonize the rules for mortgage investments made through a TIM. It does not, and hence it does not establish one set of investment tax rules when a TIM is interposed and a different set when a TIM is not in the picture. Thus, S. 1822 affords the TIM investor the same tax treatment the investor would have received had he or she instead invested directly in home mortgages. While that is a comprehensible approach, a market discount home mortgage remains a less attractive investment than a market discount corporate bond. The maintenance of that discontinuity is inappropriate. While the TIMs legislation may not be the appropriate vehicle for change, a change in basic tax rules to eliminate the inferior treatment accorded home mortgage investments is overdue.

Although S. 1822 focuses mainly on investors transferring cash to a TIM in exchange for shares, it also contemplates a transfer of home mortgages to a TIM in exchange for shares and provides that the TIM shall market-to-market at the time of the exchange. Marking to market seems appropriate in facilitating subsequent tax accounting as payments on the mortgages are received, but we believe the legislation is wholly wrong in going on to provide that the shareholder must treat the exchange as a taxable event and recognize the resulting gain or loss over the remaining term of the mortgages transferred. A simpler, less intrusive approach would treat the exchange as non-taxable, allowing the investor to account for the difference between his basis in the transferred mortgages and value at the time of

transfer over the same period and in the same way that difference would have been accounted for by the investor had there been no transfer to the TIM. Among other things, we believe, this simpler approach should make TIM investments more accessible to financial institutions that hold, at depressed values, large portfolios of home mortgages, will assist those institutions in restructuring their portfolios, and will encourage them to remain active participants in the mortgage markets.

As earlier noted, the inflexibility of grantor trusts doctrine, as currently interpreted by the IRS, prevents "call" protective reinvestment of mortgage prepayments and bars the issuance of multiple classes of mortgage-backed securities. Sensibly, S. 1822 eliminates these restrictions when a TIM is employed. It is important, however, that old and inappropriate restrictions not be replaced by new inappropriate restrictions of equal or greater magnitude. The genius of S. 1822 lies in promoting the flexibility of the marketplace. It would be wholly counterproductive, out of harmony with the salutary congressional purpose, were the legislation employed to restrict or forbid other commercially viable methods of selling mortgage-backed securities. The market operates best, affording the lowest cost to home owners and the highest yield to investors, when products actively compete. The market does not operate at greatest efficiency when competition is suppressed.

As an illustration, while IRS classically has taken an inflexible approach to grantor trusts functioning as pooled

mortgage investment vehicles, recent IRS positions have exhibited evolving flexibility in other areas of grantor trust law, particularly with regard to bond-type payment schedules of principal and interest and various guarantees of timely payment of principal and interest. While the rationale advanced for these recent IRS pronouncements does not to date suggest that the grantor trust rules hereafter will be interpreted to authorize reinvestment of prepayments and call protection, the Service positions ought to be allowed to evolve free from legislative restriction. Merrill Lynch and other investment bankers and issuers market mortgage-backed securities which, under S. 1822, will be ineligible or inappropriate for TIMs investments. The new legislation should evidence the intent of Congress to preserve and promote, rather than to discourage or forbid, a multiplication of investment choices. A contrary approach, restricting the freedom of the marketplace, would adversely affect financings for multi-family housing and, if sufficiently extreme, for commercial property mortgages and construction loans.

To limit TIMs essentially to home mortgage investments, but permit needed investment flexibility particularly in earlier years, S. 1822 catalogs the types of investments a TIM may make at various times in its life. The legislative objective is appropriate, but the catalog is inappropriately restrictive. Consistent with the limitation's purpose, greater flexibility can and should be accorded. A significant concern focuses on the

forward commitments a TIM may or must make to acquire home mortgages not then available. To protect its investors from the adverse impact of interim fluctuation in the value of those mortgages, the TIM is obliged to hedge its forward commitments. Accepted hedging techniques include purchase by the TIM of financial instrument futures, debt options, and debt warrants. These instruments should be added to the catalog of permissible TIM investments.

S. 1822 provides that a TIM may not receive income from services performed by the TIM. We assume, nonetheless, that a TIM sponsor, such as an issuer of securities and packager of mortgages for TIM investment, may provide mortgage and investor servicing for the TIM and collect a servicing fee. The legislative history should make clear that a TIM sponsor, as distinguished from the TIM itself, may, without any penalty to the sponsor or the TIM, provide its services for a fee.

Heretofore, the tax law has operated as a major impediment to investment in home mortgages and, in so doing, has run counter to sound public policy. We believe the tax law regarding mortgage credit should operate in a neutral way. It ought not discourage investment in home mortgages. By the same token, it ought not artificially to encourage these investments by allowing an investor who is earning a profit to report a tax loss. If the tax law is rendered neutral, pooled investments in home mortgages can stand on their own and compete effectively in the capital markets.

Mr. Chairman, this, I believe, defines the community of our interest. There are many legislative proposals regarding the deregulation of the nation's financial industries now pending in congress. Irrespective of the outcome of these legislative proposals, the TIMs legislation, S. 1821 and S. 1822, clearly can stand alone and ought to be enacted on its own merits. Like this Committee and the Banking Committee, we are interested in promoting a flexible and efficient marketplace for home mortgage investments. With the introduction of these two companion bills, that effort is well underway.

I thank you and the members of the Committee for the time allotted me today. I will be pleased to answer any questions from the Committee.

Senator DANFORTH. Mr. Maxwell.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, D.C.

Mr. MAXWELL. Mr. Chairman, thank you for the opportunity to appear at this hearing.

Senator Garn is absolutely right about the importance of the secondary market to housing through the remainder of this decade.

We submit that Congress should include Fannie Mae, which is the most important and most efficient privately owned institution in the secondary market, in TIM's—if it moves forward—for three very important reasons:

First, if Fannie Mae is included, as Senator Garn said, TIM's will benefit low and moderate income families because this is the market that Fannie Mae serves. No other privately owned company has this specific responsibility, which has been given to us by the Congress.

Second, Fannie Mae brings innovation to the mortgage market, as illustrated by our pioneering work in developing new mortgages to make housing more affordable for American homebuyers. No other privately owned company can or will provide this innovation to the mortgage market.

And third, Fannie Mae plays a unique countercyclical role. We are in the market year in and year out, in good times and bad, because the Congress chartered us exclusively to support the mortgage market. We can't go out of the housing business, Mr. Chairman; that's our only business. And that is not true of private firms.

TIM's could be important to Fannie Mae's financial recovery, which is now underway, in two ways: If TIM's is passed, without it our mortgage-backed security program would be much less effective. And second, if TIM's is helpful in restructuring mismatched

portfolios, obviously Fannie Mae is a strong candidate to use it in that way.

Finally, we assume Congress will want to be certain that adoption of TIM's results in lower financing costs for homebuyers and will not just result in financial benefits to others in the marketplace. We would like to work with the committee and its staff to assure that this occurs.

[Mr. Maxwell's prepared statement follows:]

31-489 O—84——14

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and Members of the Committee:

My name is David Maxwell. I am Chairman of the Board and Chief Executive Officer of the Federal National Mortgage Association.

The Federal National Mortgage Association -- also known as FNMA or Fannie Mae -- began in 1938 as a subsidiary of the Reconstruction Finance Corporation, chartered by the Federal Housing Administrator. After several reorganizations, the Congress in 1968 separated FNMA into two distinct organizations: FNMA and the Government National Mortgage Association (GNMA or Ginnie Mae). FNMA became a private corporation, listed on the New York Stock Exchange and supervised in certain respects by the Secretaries of Housing and Urban Development, and Treasury. It has a 15 person Board of Directors. Ten are elected by the 30,000 holders of its 65 million shares of stock; the remaining five are appointed by the President.

FNMA is chartered by the Congress to provide assistance, liquidity and stability to the home mortgage market. FNMA operates in the secondary mortgage market. It purchases mortgages from financial institutions, such as mortgage bankers, savings and loan associations, and commercial and savings banks, to provide them money to lend people to buy homes. FNMA has obtained the money to purchase these mortgages largely through short- and medium-term borrowings in the capital markets.

FNMA's service as a financial intermediary improves the efficiency of the housing finance market. Its operations transform mortgages from small, illiquid, and local investments into blue-chip corporate paper which attracts money to housing. The national scope of FNMA's operations has increased the flow of mortgage funds among geographic regions of the nation. FNMA has also worked with GNMA to increase the availability of low- and moderate-income housing.

The innovation and marketing efforts of GNMA, FNMA and the Federal Home Loan Mortgage Corporation (FHLMC) were responsible for the development and acceptance of mortgage-backed securities (MBSs) and TIMs-like instruments, including the FHLMC collateralized mortgage obligation (CMO), that are being offered in the market today. FNMA has been a leader in linking the housing and capital markets; we bridge the financial needs of housing and investors.

I welcome this opportunity to discuss S. 1822, which its sponsors intend to facilitate investment in home mortgages through creation of a new financing vehicle called TIMs (Trusts for Investments in Mortgages). The TIMs bill is an outgrowth of a general concept suggested two years ago by the President's Commission on Housing. We understand, however, that the Administration is preparing an alternative version of the TIMs legislation. Since we have not yet seen the Treasury bill, without knowing the details

we cannot know how important TIMs will be to the mortgage market.

Therefore, I will comment on the general concepts underlying TIMs.

I understand that the primary objective of TIMs is to help home buyers. If that is true, then FNMA, an institution established by the Congress for the sole purpose of facilitating credit for housing, should be included in TIMs.

Congress should include FNMA in TIMs for three very important reasons:

1. If FNMA is included, TIMs will benefit low- and moderate-income families because this is the market that FNMA serves.

2. FNMA brings innovation to the mortgage market, as illustrated by our pioneering work in developing new mortgages that make housing more affordable for American home buyers.

3. FNMA has a unique countercyclical role; we are in the market year-in and year-out, in good times and in bad, because the Congress chartered us exclusively to support the mortgage market.

I will elaborate on these three points below.

FNMA's Essential Role in TIMs

First, should TIMs prove acceptable to investors and bring real value to housing, the Congress can assure that low- and moderate-income home buyers benefit by including FNMA. FNMA's Charter Act, as passed by the Congress, requires us to emphasize support of the low- and moderate-income housing market. FNMA is the single largest supplier of conventional mortgage financing to low- and moderate-income families.

The unpaid principal balances of first mortgages that FNMA purchased in 1982 and the first three quarters of 1983 averaged approximately $60,000. By contrast, the major private issuers of mortgage-backed securities enjoy the higher and more profitable segment of the mortgage market. The average size loan purchased by the largest private issuer of mortgage-backed securities so far in 1983, since it first began to do a significant volume of business, has been $130,000, twice as high as FNMA's average loan purchase.

Second, FNMA has pioneered many new mortgage products to increase affordability for potential home buyers. These include buydowns,

graduated payment mortgages (GPMs) and adjustable rate mortgages (ARMs).

This innovative role in the mortgage market relates directly to the fact that we are the largest mortgage portfolio investor in the country. Our assets, comprised entirely of mortgage loans, total $75 billion. Because we are the largest portfolio investor in the country, we can purchase loans that are not yet acceptable to a broad base of capital market investors. ARMs are a perfect example.

When FNMA began purchasing ARMs in 1981, there was no consensus about the type of ARM the capital markets and home buyers wanted. Most importantly, however, home buyers were very confused about ARMs; they did not appreciate that ARMs could make it easier for them to purchase homes. The keys to the housing problem in America are financing and affordability. The most expensive part of an American house today is the cost of money needed to build and buy it. It is FNMA's job to attract much of that money to housing, as efficiently as possible.

We initially purchased over 120 different types of ARMs during 1981-1982 to help home buyers understand that ARMs could be an affordable alternative to thirty-year fixed-rate mortgages, which carried interest rates as high as 17 percent at the time. Our ARM purchases also helped home builders move their swollen

inventories of houses. FNMA was the only institution in the country capable of providing this support. We were able to do this because of our portfolio lending role.

This portfolio role, which is so essential to the market, is not without its risks, however, which is why no firm in the secondary market wants to compete with us in purchasing loans to be held in portfolio. FNMA suffered losses of nearly $300 million in 1981 and 1982 as short term interest rates skyrocketed substantially above the yield on our portfolio of predominantly thirty-year, fixed-rate mortgages. While we have earned a profit of over $60 million during the first three quarters of 1983, we must employ every strategy we can to balance this risk in the future so that we can continue our indispensable role in supporting the housing and mortgage markets. Our mortgage-backed securities (MBS) program is a critical element in that balance.

FNMA instituted a self-help financial recovery strategy two years ago to repair our mismatch of assets and liabilities -- a strategy to help housing while helping ourselves. Its key elements are:

- purchasing higher-yielding and shorter-term assets to offset the losses on the existing low-yielding, fixed-rate portfolio;

- launching a mortgage-backed securities program to enable us to continue to support the mortgage market in a less risky manner; we have issued over $26 billion of these securities in two years; and,

- lengthening the maturity of the debt we raise to finance our portfolio purchases.

TIMs is important to FNMA's financial recovery in two ways. First, our MBS program can continue to compete in the marketplace and benefit the thousands of families we serve every year if we are included in TIMs. Without TIMs, our MBS program would be much less effective. Second, if TIMs is to be used, as some have advocated, primarily as a way to help thrift institutions restructure their mismatched portfolios, FNMA can use TIMs in exactly the same way. This would be a big boost to our self-help strategy, enabling FNMA to get back on its feet financially more quickly.

Thus, our essential portfolio role in bringing affordable mortgage instruments to market and the future success of our MBS program in balancing the risk inherent in that portfolio role argue strongly for FNMA's inclusion in TIMs.

Third, FNMA performs a key countercyclical role by maintaining

a stable flow of money into the mortgage sector. The housing industry is extremely vulnerable to high rates. During periods of credit shortages and high interest rates, housing construction declines, building tradesmen are unemployed, and many Americans are unable to buy homes. In the past, FNMA's extensive mortgage purchases during these periods have helped prevent a collapse in housing.

During the troubled times of 1982, FNMA purchased nearly $15 billion in mortgages -- one in every seven loans originated. We also issued nearly $14 billion in mortgage-backed securities. Many of the loans we purchased in 1982 were made through special arrangements to help builders sell houses. For much of 1981 and 1982, FNMA was called "the only game in town" in the secondary mortgage market.

As Senator Tower stated in introducing S. 1822: "They [FNMA, FHLMC and GNMA] are to be congratulated for their successful accomplishment of the public policy goals of housing and support during periods of economic distress." It is the countercyclical role of FNMA to support housing finance during periods of high interest rates such as we now experience that has been of prime importance to home buyers.

If FNMA is included in TIMs, home buyers, home builders and mortgage lenders will benefit from our countercyclical role

because TIMs can then be a vehicle to provide credit for housing at all points of the interest rate cycle. Our sole dedication to housing finance provides this essential funding as other market participants withdraw from the market when housing credit is short.

Who Will Benefit From TIMs?

We assume Congress will want to be certain that adoption of TIMs results in lower financing costs for home buyers -- and not just in financial benefits to middlemen in the marketplace. In weighing this question, the Committee will, of course, bear in mind that a TIM is not only a new version of a mortgage-backed security, but could also be a new form of tax-exempt corporation.

As the key link between the mortgage and capital markets, FNMA is expert in devising ways for home buyers to obtain affordable credit. We would be very pleased to work with the Committee and its staff to assure that TIMs benefit home buyers, especially those who are less affluent and have fewer options to obtain mortgage credit.

Summary

FNMA brings substantial positive benefits to TIMs, and I recommend strongly that we be included. In carrying out our congressionally mandated responsibilities, FNMA performs three functions that

bear directly on the potential effectiveness of this new initiative in meeting its objective of funneling additional capital to America's home buyers:

- we primarily serve the low- and moderate-income housing market;

- we have pioneered, and will continue, in bringing innovative mortgage products to the market -- products designed to make housing more affordable; and,

- we serve a countercyclical role, assuring as best we can that during periods of credit shortages and high interest rates that a housing downturn does not become a housing catastrophe.

Mr. Chairman, I very much appreciate this opportunity to testify on TIMs. I look forward to working on this legislation with you and with all others interested in an America where everyone who wants to buy his or her own home can afford to do so.

Senator DANFORTH. If Fannie Mae is able to issue a TIM's security, won't the Fannie Mae instrument dominate the market?

Mr. MAXWELL. No, sir. In our view it will not. Just as Mr. Ranieri referred to a "growing private sector issuance of mortgage-backed securities at the present time," we feel that this will develop and that Fannie Mae's participation will, in fact, help it to develop.

Senator DANFORTH. Does Mr. Maxwell speak for everybody?

Mr. RANIERI. I don't think that the inclusion of Fannie Mae will overwhelm the private sector in the nonconforming area. I think if Fannie Mae or Freddie Mac were to be included, it is true that the private sector could not outbid them, so that everybody would keep their proportionate share of the market, in other words, the agencies would operate in the area of $108,000 and below, and the private sector would operate in the area above that. Unless you raise the loan limit, I don't see how Fannie Mae could invade that territory now operated by the private sector.

Mr. PRATT. Essentially, I would join Mr. Ranieri's remarks. I think the inclusion of Fannie and Freddie in what is now eligible product has little effect on the private market aspects of this instrument. It would have much more substantial aspects if the inclusion within TIM's had the effect of removing the limits on the price levels under which they can operate.

Mr. MCCAULEY. Our firm supports the role for Freddie Mac and Fannie Mae. We think it is important that they help lead the market in its development stages. This is a rather undeveloped market that we are talking about, and just as Ginne Mae helped back in 1970 to introduce the passthrough mortgage product to the secondary market, we believe that it is important at this point for them to lead us into that market as well.

Senator DANFORTH. Would we, through this legislation, be creating an enhanced mortgage-backed security which would compete with corporate instruments to the detriment of the marketplace and to the detriment of capital investment in plant and equipment?

Mr. PRATT. I think that in this regard what we are seeing is an increase in the efficiency of capital markets, whereby all types of instruments compete more fully with all others. The way that mortgages may have competed with corporates in the past was through the channeling of credit through sheltered financial institutions that were protected by regulation. As those have been removed, I think we are seeing the more direct competition. I don't see any detriment to corporate markets from this; but in fact they are probably more efficient an allocation of capital, based on needs at various times.

Mr. RANIERI. I echo Mr. Pratt's statement. I don't see that this is a detriment to the capital market. You would, however, be making the process of raising capital for mortgages much more efficient. And if in doing so you could thereby assume you were competing more aggressively with corporate America, I guess you could make that argument; but it doesn't seem to me to be a very potent one.

Mr. MAXWELL. The central fact about the mortgage market today is that it is becoming linked to the capital market. Homebuyers are going to have to compete for capital with corporations. It is home-

buyers who suffer when mortgage interest rates rise. So, we submit that there is no undue allocation of capital to housing under the existing institutions; nor, because of this linkage and because of the need for homebuyers to compete, would there be such under this proposal.

Mr. McCAULEY. The linkage to the capital markets is evidenced by the types of securities that our market has created in the last 6 months—the CMO security, for instance, is more like a corporate bond, and it allows the market to discern values between those two and on a more fair basis.

Senator DANFORTH. Gentlemen, thank you very much. That concludes the hearing.

[Whereupon, at 11:56 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

November 18, 1983

The Honorable Robert J. Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This statement is submitted for the record in conjunction with the Committee's hearing on Trust for Investment In Mortgage legislation, S. 1822. The American Bankers Association is the trade association of the U.S. commercial banking industry annnd represents approximately 90% of the more than 14,000 full service commercial banks, all of which participate in the housing market by providing funds for housing the nation.

Our Association has testified twice this year before the Senate Committee on Banking, Housing and Urban Affairs, in support of the TIMs concept because it is our feeling that this initiative will facilitate the flow of mortgage credit in the private sector by expanding the number of entities delivering mortgages in the private secondary market. For the TIMs concept to successfully operate, we believe that some modifications of the tax code must be made as set forth in S. 1822. We urge your Committee to make these changes.

ABA previously testified that the housing needs of the nation can best be filled by a freely competitive primary and secondary housing finance market. Through the first eight months of 1983, banks originated over $26 billion in mortgage loans for 1-4 family nonfarm homes, over twenty percent of the total funds provided by all organizations. At the end of June, 1983, commercial banks held $162.6 billion in residential mortgages with additional billions in mortgage securities being held by bank trust departments. In regards to the secondary market, banks held $10 billion in debt securities of the three sponsored secondary market agencies -- the Government National Mortgage Association (GNMA), the Federal National Mortgage Corporation (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Bank trust departments hold nearly $11 billion of mortgage pass-through certificates and banks themselves continue to hold over twenty percent of the total outstanding debt issues of the FNMA. Furthermore,

bank commitment to the secondary market is evidenced through the ownership of mortgage banking affiliates which originate loans for sale in the secondary market. Of the top 100 mortgage bankers, 46 are bank affiliated.

The ongoing deregulation of financial institutions has increased the need for mortgage lenders to rely on the secondary market. The importance of the secondary market will increase as deregulation proceeds and the role of depository institutions changes. To the extent market participants are free to create new and attractive mortgage-related securities, as would be permitted by S. 1822, the Trust for Investments in Mortgage Act, the flow of capital from investor pools of funds to homeowners would be facilitated.

The TIMs concept is a collection of proposed statutory and regulatory changes designed to remove current legal impediments, and encourage the broad acceptance of, new and improved forms of conventional mortgage-backed securities. In essence, the TIM would be allowed to manage cash flows from its mortgage related investments to create multiple classes of securities with different maturities and yields, with gains taxable to the investor and not the TIM.

Currently, many potential suppliers of funds to the housing market are inhibited by regulations that essentially limit purchase of instruments backed by mortgages to potential participants including insurance companies, pension funds and bank trust departments. The most significant restraints on development of more creative mortgage-backed securities are contained in the securities laws, ERISA and the tax laws. Certain regulations of the Federal Reserve System and the other banking regulatory agencies as well as a variety of state laws also need change. Several recent efforts to alleviate the regulatory burden are encouraging. For example, the SEC has expedited the process for registration of mortgage-related securities by allowing blind pool registration. Now a pool's prospectus need only describe the mortgage in generic terms, while actual pool data may be provided to pool investors at a later date. Another change relates to the fact that the Federal Reserve now permits conventional mortgage-backed securities to be used as collateral for margin credit with securities dealers. Further, the Department of Labor has granted exemptions which address the problems of ERISA. Much has been done but much more is needed.

The most significant obstacle remaining is the Internal Revenue Code which imposes double taxation on conventional mortgage-backed pass-through securities — at both the pool level and investor level. In order for a pass-through pool to avoid this double taxation, it must qualify as a grantor trust. However, as interpreted by the IRS, the grantor trust is extremely inflexible, requiring that the security closely resemble the characteristics of the pool of underlying mortgages. Further, the grantor trust restricts the trustee from actively managing the assets of the trust, therefore, the trustee has little ability to manage the cash flows of the

pool. Without active management, the pool is unable to provide protection from mortgage prepayment, commonly referred to as call protection, for the investors, nor would it be able to insulate itself in a rising interest rate environment.

Today mortgage pass-through securities cannot compete with corporate bonds because the characteristics which make bonds attractive to bank trust departments, pension funds and others — liquidity, semiannual payment of interest, predictable maturity schedule, safety and call protection — are not necessarily present in a mortgage-backed security. If one can make mortgage-backed securities more competitive with corporate bonds, then more funds might be attracted to the housing market. S. 1822 will resolve the tax problems and will permit greater flexibility in the development of new types of mortgage-backed securities. By creating a new form of flow-through entity for mortgage securities which allow for call protection and for multiple classes of securities, additional capital may be attracted to this market.

Our Association also supports Fannie Mae's and Freddie Mac's participation in a TIMs program provided there is an acceptable, agreeable and appropriate phase out of the government benefits which these organizations currently enjoy. TIMs securities issued by government or quasi-government agencies would trade at a competitive advantage over TIMs securities issued by private sector corporations. Our concern is that the new players in the secondary mortgage market, the private-sector players not be stifled in their development. We would continue to urge you, Mr. Chairman, and the members of Congress to play an active role in assuring the maintenance of a procompetitive environment.

Mr. Chairman, the Administration has been developing its own TIMs proposal and testified in these hearings that it will be offering its proposal in the near future. Our Association is assembling a Task Force with representation from all affected parts and functional areas of the banking industry to study the various TIMs proposals and offer suggestions and guidance as to what might provide the most flexible and workable format in the marketplace.

As the work of our Task Force proceeds, and as you continue your deliberations on this important matter, we hope that a continuing dialogue might be possible to ensure that a valuable TIMs product emerges.

Sincerely,

Gerald M. Lowrie
Executive Director
Government Relations

MORTGAGE INSURANCE COMPANIES OF AMERICA
1725 K STREET, N.W., SUITE 1405 — WASHINGTON, D.C. 20006 — (202) 785-0787

November 2, 1983

JOHN C. WILLIAMSON
EXECUTIVE VICE PRESIDENT

STEVEN P. DOEHLER
STAFF VICE PRESIDENT

The Honorable Robert Dole, Chairman
Senate Finance Committee
221 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Dole:

The Mortgage Insurance Companies of America (MICA)* would like to offer a statement for the Committee's hearing record in strong support for the Trust for Investment in Mortgages Act of 1983, S.1822. The tax law changes proposed in the legislation will help the private sector create a new entity to conduit savings and other capital into housing. The system for financing housing will benefit from a more competitive form of mortgage security defined and referred to in S.1822 as TIMs.

As a result of deregulation of financial institutions, especially actions providing broader asset powers to traditional mortgage lenders, there has become an enhanced need for ongoing improvements in the secondary market. The changes proposed by S.1822 will facilitate the creation and marketing of attractive mortgage securities by permitting a trustee greater flexibility to manage the trust collateral and better meet investor needs. Uncertain cash flows and the absence of call protection are examples of problems resulting from mortgage securities trammelled by the grantor trust mechanism. Active management of mortgage pool cash flows can be successfully introduced and controlled for the marketing of mortgage securities.

* MICA consists of thirteen domestic private mortgage insurance companies whose insurance-in-force on September 30, 1983 was $141 billion. The national officers are Leon T. Kendall (Chairman of the Board of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, President; William A. Simpson (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Vice President; Claude E. Pope (President of General Electric Mortgage Insurance Companies), Raleigh, North Carolina, Treasurer; Henry D. Felton (President of Commercial Credit Mortgage Insurance Company), Baltimore, Maryland, Secretary; and John C. Williamson, Executive Vice President and Steven P. Doehler, Staff Vice President Washington, D.C.

AMERICAN MORTGAGE INSURANCE COMPANY ☐ COMMERCIAL CREDIT MORTGAGE INSURANCE CO. ☐ COMMONWEALTH MORTGAGE ASSURANCE COMPANY ☐ FOREMOST GUARANTY CORPORATION ☐ HOME GUARANTY INSURANCE CORPORATION ☐ INSMOR MORTGAGE INSURANCE COMPANY ☐ INTEGON MORTGAGE GUARANTY CORPORATION ☐ MORTGAGE GUARANTY INSURANCE CORPORATION ☐ PMI MORTGAGE INSURANCE CO. ☐ REPUBLIC MORTGAGE INSURANCE COMPANY ☐ TICOR MORTGAGE INSURANCE COMPANY ☐ TIGER INVESTORS MORTGAGE INSURANCE COMPANY ☐ THE MORTGAGE INSURANCE COMPANY OF CANADA ☐ UNITED GUARANTY CORPORATION ☐ VEREX ASSURANCE INC

While we support more flexible mortgage investment trusts, we caution that some standards be established to guide the market initially and avoid even a few isolated problems which could undermine investor acceptance of a TIMs. Tax code changes which will permit new trust devices to be created, issued and managed should incorporate prudent standards as an essential element of the legislation. The goal should be to promote the development of the private securities market by including standards in S.1822 that define the quality of the collateral that backs the mortgage trust securities.

Investors including pension funds, financial institutions or individuals should be afforded at least the basic safeguards in a mortgage security sold by an investment trust as they are offered in the private secondary mortgage market. Therefore, a specific change should be made in Section 860E(b) part 3 of the bill which sets forth criteria of mortgages eligible for inclusion in TIMs. This section currently states that the outstanding principal balance of such mortgages shall not exceed the fair market value of the residence upon which the mortgage has been made. Such criteria would permit obligations representing financing up to 100% of value to be eligible for TIMs. This is far too liberal a standard which we feel would be imprudent. We urge this Section be amended to limit eligible mortgages to those which do not exceed 95% of the fair market value. The extreme default risk involved in conventional mortgages representing 100% financing with no equity interest by the mortgage borrower has been documented, but more importantly this type of financing is not accepted at this time by the private market. In fact, there are state laws which restrict the availability of loans in excess of 95% of value which have been enacted because of an evaluation of the risk involved. The new mortgage investment trusts should not encourage trustees to purchase for the beneficial interest of investors pool collateral that does not have an acceptable risk level in the conventional market.

MICA also recommends that the eligible collateral requirements of a TIM match the conventional purchase requirements provided in the charters of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The Congress has expressed concern over the level of risk the federally sponsored agencies were reasonably expected to bear in establishing mortgage purchase safeguards for these agencies and there has been no lessening of these safeguards. They should be incorporated in S.1822 as set forth below.

We recommend Section 860E(b) of S.1822 include an amendment which will limit eligible collateral of first or second mortgages to (1) not exceed the financing limit of 95% of market value and (2) meet certain minimum purchase requirements comparable to those presently imposed by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. We are attaching a proposed draft of an amendment to S.1822 to accomplish this objective.

MICA urges the Committee to act favorably on S.1822 because in our view it will help improve the expanding linkage of homebuyers to the capital markets. The mortgage insurance industry has extensive experience in looking at risk variables resulting from mortgage instrument design and from the practices of appraisers, underwriters and security issuers. Default insurance, our industry's traditional role, has proven to be a dynamic concept. It has spawned the development of many additional services that facilitate the origination and sales of mortgages but its greatest potential lies in encouraging the private market to meet investor needs as they evolve. We support changes that will help the housing market and the consumer. We further believe that such changes must promote greater reliance upon the private sector and reserve for the government those activities that the private sector cannot perform. It is in this regard we strongly support Section 860A(g) making the federally sponsored agencies ineligible for TIMs.

We thank the Committee for accepting these views in the hearing record and MICA stands ready to provide any additional information the Committee may deem useful.

Sincerely,

Steven P. Doehler

SPD/mbg
Enclosure

PROPOSED AMENDMENT TO S.1822, TRUST FOR INVESTMENT IN MORTGAGES

1. Amend section 860E(b)(1) by adding a new paragraph (C) as follows:

"(C) is, in the case of a first mortgage, insured by an insurer, deemed qualified by the Federal Home Loan Mortgage Corporation, to the extent of that part of the mortgage in excess of 80 per centum of the value of the property securing the mortgage; and in case of a second mortgage only if the total outstanding indebtedness secured by the property does not exceed 80 per centum unless the excess over 80 per centum is insured by a qualified insurer as defined above."

2. Amend section 860E(b)(3) to read as follows:

"(3) MORTGAGE MAY NOT EXCEED NINETY-FIVE PER CENTUM OF VALUE - The principal amount of any qualified first or second mortgage on any residence, when added to the aggregate principal amount of all previous such mortgages on such residence, shall not, on the date such mortgage is issued, exceed ninety-five (95) per centum of the fair market value of such residence on such date."

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
before the
SENATE FINANCE COMMITTEE

On behalf of the more than 600,000 members of the NATIONAL ASSOCIATION OF REALTORS®, we are pleased to submit for the record the following testimony to the Senate Finance Committee as it deliberates S. 1822, a proposal to establish Trusts for Investments in Mortgages (TIMs).

As a result of the ongoing deregulation of financial institutions, there has been an increased need for mortgage lenders to rely on the secondary market. It is the position of the Association that as a matter of public policy, legal, regulatory, and tax impediments to the development of broad and active markets for conventional mortgage-backed securities should be eliminated. In this vein, we applaud the Committee leadership for conducting hearings on this subject.

Generally, S. 1822, as introduced by Senators Garn and Tower, would amend the Internal Revenue Code of 1954 to encourage investment in mortgage-backed securities through the creation of Trusts for Investments in Mortgages (TIMs). While this Association has been interested in a potential Administration version of a TIMs legislative proposal, we support the use of S. 1822 as a vehicle for achieving the goals of TIMs. However, as currently written, S. 1822 would prohibit the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) from being a TIM manager, director, trustee or shareholder. This exclusion will place Fannie Mae and Freddie Mac at a distinct competitive disadvantage with private sector issuers and is

in conflict with the need to establish the broadest and most active market possible for mortgage-backed securities.

In a letter dated October 26, 1983 (hereby incorporated by reference), to Treasury Secretary Donald Regan, Senate Banking Committee Chairman Jake Garn, a co-sponsor of S. 1822, expressed a similar concern stating that ". . . it is not feasible nor appropriate, in my judgment, at this time to pursue actively proposals that would reduce the Federal benefits that FNMA and FHLMC now enjoy while this building process is occurring. Continuation of the ready flow of capital to housing that those benefits create is essential for a healthy economy."

The NATIONAL ASSOCIATION OF REALTORS® strongly favors involvement by these two institutions as they have proven to be and continue to be viable, stable sources of housing credit in both good times and bad. Therefore, it is the recommendation of the Association that S. 1822 be amended to include Fannie Mae and Freddie Mac's participation in this embryonic market in order to achieve the goal of creating the broadest and most active market possible for TIMs.

Mortgage assets can be integral elements of profitable portfolios for many types of institutions so long as tax, legal and regulatory factors do not make mortgage instruments unattractive relative to other types of investments available in the marketplace. The major tax issues the Committee will focus on in its deliberations of S. 1822 revolve around the current grantor trust rule that is presently utilized for mortgage-backed pass-through securities. While the grantor trust rule enables mortgage pools that pass through interest payments and principal payments to security holders to avoid taxation at the pool level (similar to the TIMs proposal), the application of the grantor trust procedure

has proven to be extremely inflexible. Under the current structure, active management of the pool after its formation is generally impossible.

S. 1822 would allow for an active management of the trust where the trustee is provided with greater management flexibility. By permitting greater flexibility in pool management, without the danger of taxation at the pool/issuer level, a broader range of investors will be brought into the market. By allowing for multiple classes of securities, investors will be provided "call protection" since prepayments could be applied toward another class of securities, thus making TIMs highly marketable. The NATIONAL ASSOCIATION OF REALTORS® supports these provisions.

The National Association is concerned about the prohibition against TIMs investment in multi-family mortgages as the Association has historically supported pension fund investment in this area. Hence, the Association would conceptually support an amendment to S. 1822 which would permit TIMs investment in such mortgages provided they meet investment standards similar to those imposed upon pension funds investment in multi-family mortgages.

The NATIONAL ASSOCIATION OF REALTORS® also notes, with concern, that as currently written, S. 1822 contains no qualification criteria for trustees or managers of a TIM. We would urge that such criteria be included to ensure that those chosen to be trustees or managers are capable of administering a TIM so that the future credibility and quality of privately issued mortgage-backed securities is not impaired.

We would like to point out to the Commitee that certain administrative changes necessary for a successful TIMs market have been implemented in the recent past. For example, the SEC has expedited the process for registration

of mortgage-backed securities to be used as collateral for margin credit with securities dealers. The Association applauds these actions.

In conclusion, we would reiterate our grave concern regarding the ineligibility of Fannie Mae and Freddie Mac to be trustees, directors or shareholders of a TIM. By excluding Freddie Mac, in particular, we believe that the housing industry would be deprived of the Corporation's traditional innovative role--a role that has provided the private sector with a successful working model of new programs. For example, Freddie Mac's recent design and introduction of the Collateralized Mortgage Obligation (CMO) is regarded by many to be the forerunner of TIMs. Based on Freddie Mac's success with the CMO, it is our understanding that Fannie Mae plans to design and introduce a similar instrument. At a time when traditional sources of mortgage credit are drying up, the creative abilities and expertise that these two institutions possess can only benefit the mortgage marketplace.

The NATIONAL ASSOCIATION OF REALTORS® wishes to express its appreciation to the Committee for the opportunity to submit this testimony for the record and would be pleased to respond to any questions the Committee may have.

JAKE GARN, UTAH, CHAIRMAN

JOHN TOWER, TEXAS
JOHN HEINZ, PENNSYLVANIA
WILLIAM L. ARMSTRONG, COLORADO
ALFONSE M. D'AMATO, NEW YORK
BLAIR GORTON, WASHINGTON
PAULA HAWKINS, FLORIDA
MACK MATTINGLY, GEORGIA
CHIC HECHT, NEVADA
PAUL TRIBLE, VIRGINIA

WILLIAM PROXMIRE, WISCONSIN
ALAN CRANSTON, CALIFORNIA
DONALD W. RIEGLE JR., MICHIGAN
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
FRANK R. LAUTENBERG, NEW JERSEY

M. DANNY WALL, STAFF DIRECTOR
KENNETH A. MCLEAN, MINORITY STAFF DIRECTOR

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

October 26, 1983

The Honorable Donald T. Regan
Secretary of the Treasury
Washington, D.C. 20220

Dear Secretary Regan:

I am writing you as Chairman of the Cabinet Council on Economic Policy which is considering policy issues and legislation regarding the secondary mortgage market.

As you know, Senator Tower and I have been actively involved in developing legislation that will enhance the private sector's ability to provide liquidity in the capital markets for mortgages. We have also closely examined the role of FNMA and FHLMC in creating and maintaining a climate of acceptability for mortgage related securities in the investor community. After carefully exploring and considering many possible plans for reducing the reliance on the government-related borrowing of these agencies, I have concluded that the most appropriate and only prudent approach is to first allow the private secondary market to develop before disturbing the essential support to housing that FNMA and FHLMC now provide.

I believe that the enhancements for privately issued mortgage backed securities contained in S.1821 reported by this Committee and in S.1822, under consideration by the Finance Committee, will create the necessary regulatory and tax environment for the private sector to become the supplier's of the enormous capital needed by the public for home finance. At the same time it is not feasible nor appropriate, in my judgment, at this time to pursue actively proposals that would reduce the Federal benefits that FNMA and FHLMC now enjoy while this building process is occurring. Continuation of the ready flow of capital to housing that those benefits create is essential for a healthy economy. Furthermore FNMA's difficult financial position indicates that any significant changes must be approached very cautiously.

Consequently I believe it is in the best interests of the economy and the Administration's policy objectives to refrain at this time from further pursuit of schemes to remove government ties from FNMA or FHLMC.

Sincerely,

Jake Garn

JG/pad

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE

The Public Securities Association welcomes this opportunity to express its support for the objectives of Senate Bill 1822, also known as the "Trust for Investment in Mortgages Act of 1983", (the "TIMS" legislation). Together with its companion piece of legislation, Senate Bill 1821, the "Secondary Market Enhancement Act of 1983," this proposal would remove many of the statutory and regulatory impediments which have prevented privately issued conventional mortgage-backed securities from becoming a more efficient means of financing residential housing. Moreover, this legislation will foster the creation of a well-balanced mortgage credit distribution system and will promote the linkage between the nation's capital markets and its mortgage credit markets, to the benefit of all homebuyers.

PSA is the national trade association which represents the banks and securities dealers which underwrite, trade and sell mortgage-backed securities, U.S. government and federal agency securities and state and municipal securities. Included among our membership of approximately 300 firms are all the leading mortgage-backed securities dealers, many of whom have already individually testified on the TIMS legislation.

The residential secondary mortgage market is of rather recent origin. The first secondary mortgage market transaction between two savings and loan institutions took place in 1949. This market is the principal means by which thrift institutions and other mortgage originators are able to sell newly originated mortgages, or older mortgages held in portfolio, to raise capital to finance new mortgage loans. This has been accomplished through the sale of either whole mortgages or through the use of mortgage-backed securities. Mortgage-backed securities have provided the advantages of greater liquidity and diminished risk of loss than the purchase of individual whole mortgages.

Historically, the function of this market was to redistribute funds among various areas of the nation which might have been facing regional mismatches in the cost and availability of mortgage credit. For example, many slower growing areas of the country faced periods of time where there was a greater supply of mortgage credit available for lending than demand for it by local homebuyers. Conversely, many of the faster growing areas of the country frequently had greater demand for mortgage credit than dollars available to lend. The secondary mortgage market by purchasing mortgages in the faster areas of growth and selling them in the slower growth regions, redistributed available mortgage funds throughout the country. This system proved to be adequate for many years.

Through the years the Congress has taken a leadership role in developing the residential secondary mortgage market. The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC") have each been and should continue to be important elements in this market's projected growth. Collectively, these federally created organizations have been responsible for issuing approximately $250 billion in mortgage backed securities. However, today, additional sources of investment in residential mortgages are necessary because nationwide demand for mortgage credit has increased more rapidly than the deposit bases of traditional mortgage lending institutions.

It has been estimated that the total mortgage credit need for 1983 could exceed $170 billion. In order to efficiently provide this staggering volume of mortgage credit, we urge the Congress to begin to take steps to promote more efficient means of securitization and sale of mortgage-backed securities. (For purposes of this statement, securitization means the process by which large numbers of mortgages are pooled into mortgage-backed securities which are subsequently sold in fractionalized form as security interests in the pooled mortgages.) Without enactment of legislation like the TIMS proposal less than half of 1983's total mortgage credit demand will be provided through securitization.

Over the next decade it has been estimated that $4 trillion dollars will be needed to finance housing in this country. The only way to satisfy this enormous demand for mortgage credit is to encourage additional access to our nation's capital markets from the private sector. This can best be accomplished through a mechanism which allows private issuers to efficiently securitize mortgages. The TIMS legislation represents a significant positive step in this direction.

We anticipate many benefits from the TIMS legislation. In our opinion, the most significant of these benefits will be the creation of a new type of flexible mortgage trust instrument under the tax code. At the present time, pools of mortgage-backed securities are typically organized in the form of "grantor trusts." Unless organized in this fashion, pools of mortgage-backed securities would be subject to taxation at both the pool-level and at the investor level. Furthermore, grantor trusts must be operated under completely passive management. This requires the pool of mortgages to be established at the outset, to be self-liquidating with no ability for reinvestment, and to remain effectively unaltered after its initial formation. These, limitations have created uncertainty among investors as to the maturity and yield on the security purchased, and, more generally and has served to restrict the marketability and attractiveness of mortgage-backed securities.

To a substantial degree these problems are alleviated by the TIMS proposal. S.1822 would permit the creation of a tax-exempt entity whose trustee is permitted to manage the pooled assets and to reinvest cash flows from the underlying mortgages. These features could be used to create different classes of securities based on the maturity and cash flow preferences of different types of investors. For example, this would permit the creation of mortgage securities that provide thrift institutions with the short maturities they need to match against their short-term liabilities; life insurance companies with the medium-term maturities they desire; and pension funds with the stable long-term maturities which they prefer.

It is reasonable to anticipate that the increased marketability of these type of securities will result in more advantageous pricing. Greater competition among mortgage lenders at the origination level, as well as greater competition among mortgage-backed securities dealers to serve as market makers in these securities should lead to this result. As the secondary mortgage market becomes even more liquid and efficient we also expect to witness a narrowing in the yield spreads between mortgage-backed securities and Treasury securities. Lower mortgage interest rates at the origination level should result, significantly benefiting potentional homebuyers.

There are other benefits which we expect to realize as a result of enactment of the TIMS proposal. For example, the TIMS legislation would permit the issuer to market securities more effectively prior to delivery of the mortgage loans. According to S.1822, the issuer of the TIM would be permitted to take up to 18 months to acquire and place mortgages in the pool and is given a great deal of latitude to make interim investments. As mortgage loans become available for inclusion in the trust, the short-term investments made by the trustee would be liquidated to effectuate purchases of those additional obligations.

As noted earlier, the TIMS legislation will permit more active management of pools of mortgages. This feature will also have the positive effect of promoting investor protection against early redemption of the underlying mortgages by permitting reinvestment of cash flow and distribution at a later date. The reinvestment feature which would be restricted to only certain qualified assets would result in much greater predictability of investment terms by mortgage-backed securities investors.

Another structural benefit to be realized by the market as a result of the TIMS legislation will be the conversion of payment features to permit semiannual or annual payments of interest to investors. Investors by and large seem to prefer this feature over monthly payments since, from their perspective, it obviates

the need for monthly reinvestment decisions and offers a feature more closely in-line with the traditional payment schedules offered by other forms of fixed income securities.

The TIMS legislation will also benefit the market for mortgage backed securities by establishing the ability to obtain third-party guarantees to ensure reinvestment of assets of the trust at agreed upon rates. This guaranteed return on available cash flow pending distribution to investors should provide greater flexibility in structuring mortgage-backed pools and could help stabilize total investment returns.

We also believe that the development of an efficient and liquid conventional mortgage-backed securities market will be of great assistance to the thrift industry. In our judgment, the TIMS legislation will provide the thrifts with a very valuable tool for asset and liability management. To reduce interest rate risk in their future operations, the thrifts will be encouraged to develop more of a mortgage banking attitude to "originate and sell" instead of their traditional attitude of "originate and hold." Since conventional mortgage-backed securities will be highly liquid and more marketable than whole loans the thrifts could continue to originate long-term fixed rate mortgages and would be able to securitize them easily, maintaining a high degree of liquidity and consequently reducing the historical mismatch between their long-term assets and short-term liabilities.

For these reasons, we strongly support the objectives of the TIMS legislation. This proposal, along with its companion bill S.1821, will remove many of the legal impediments which have heretofore prevented the development of a larger and more efficient conventional mortgage-backed securities market.

○